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8 December 2011

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

By Email: www.aemc.gov.au

Dear ~~Mr Pierce~~, John

Consolidated Rule Request - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

United Energy (UE) and Multinet Gas (MG) welcome the opportunity to lodge this joint submission on the recent Rule change proposals from the AER and the Energy Users Rule Change Committee (EURCC). We note that the ENA has also provided a submission in response to the proposed Rule change. UE and MG were active participants in the ENA process and support that submission. We note that the ENA response is broadly based – this submission provides the views of UE and MG.

As explained in the attached paper, UE's and MG's cost and service performance demonstrates that properly constructed incentive-based regulation can deliver substantial benefits to customers and shareholders. This is supported by analysis made public by the EUAA.

The AER, in its rule changes change proposal, effectively states that it wishes to provide incentives for efficiency and wishes to have the power to drive out inefficient costs. You would expect that efficient performers such as UE and MG would support these objectives – and we do. However we are very concerned by the AER's rule change proposals, because we believe that they run counter to the stated objectives.

An acknowledged lack of understanding of the spending needs of distribution businesses, coupled with a wide discretion to disregard the plans and forecasts put forward by the businesses is a recipe for significant regulatory failure. We are concerned that the discretions which are meant to incentivise efficient businesses, could serve to penalise those same efficient businesses (who have less capacity to absorb revenue/cost cuts than inefficient businesses).

If the AER is going to disregard the plans and forecasts of the businesses and take responsibility for forecasting expenditure themselves, the AER will be exposed if a network company fails to meet its compliance obligations or if reliability deteriorates.

The AER's concerns regarding the current Rules are based on a view that companies produce upwardly biased forecasts that the AER is unable to correct. However, this view gives no weight to the incentives for efficient forecasting that are built into the current Rules, and the statutory declarations provided by the CEO, which certify that the key assumptions underlying the expenditure forecasts are reasonable. The AER should have confidence that the incentives and statutory declarations ensure that the forecasts are not biased.

The AER and the EURCC argue that the Rules in relation to the WACC unduly favour the network businesses. The AER comments that the WACC is under constant review and that network companies

have successfully appealed the AER's recent WACC decisions by cherry-picking particular WACC parameters. The EURCC argues that the actual cost of debt is below the benchmark allowance and that companies should not be able to profit from raising cheaper debt.

UE and MG acknowledge that the WACC has been contentious over the last few years. This is not surprising given:

- WACC drives a major proportion of network prices
- There has been a global financial crisis that has made debt and equity raising difficult and has made the WACC parameters volatile
- The AER has been found to have made significant errors in its WACC determinations

UE and MG therefore do not share the AER's concern about 'constant review' of the WACC. Concerns of 'constant review' should not be a justification to remove scrutiny or to seek administrative ease.

The views expressed by the AER and the EURCC in relation to WACC underestimate the volatility in financial markets and the importance of investor confidence. It is important that theoretical arguments, or administrative convenience do not stand in the way of the commercial realities of raising debt and equity. Investors must be confident that regulation will deliver stable and reasonable outcomes, and access to merits review is an important factor in providing this confidence.

The EURCC has developed some interesting proposals for how the cost of debt should be addressed in future regulatory determinations. There are some difficulties with the EURCC's approach. For example, the proposed credit rating range of A to BBB does not recognise the importance of ensuring consistency across WACC parameters, such as gearing assumptions and the value of the equity beta. However, there are elements of the EURCC's proposal that should be carefully considered, such as the possibility of developing an averaging approach to the cost of debt. Given the complexity of the issues raised by the EURCC, the attached submission should be regarded as providing our preliminary views only.

UE and MG would be pleased to respond to any queries the Commission may have in relation to this submission, or to provide further evidence or analysis to assist the Commission's consideration of the Rule change proposals. Please contact Andrew Schille, (General Manager Regulation, United Energy and MG Gas on 03 8846 9860) in the first instance.

Yours sincerely,

Hugh Gleeson
Chief Executive Officer

8th December, 2011

Consolidated Rule Request - National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2011

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1 Introduction and overview of submission

1.1 This document is a joint submission lodged by United Energy (UE) and Multinet Gas (MG) in response to recent Rule change proposals from the AER and the Energy Users Rule Change Committee (EURCC).

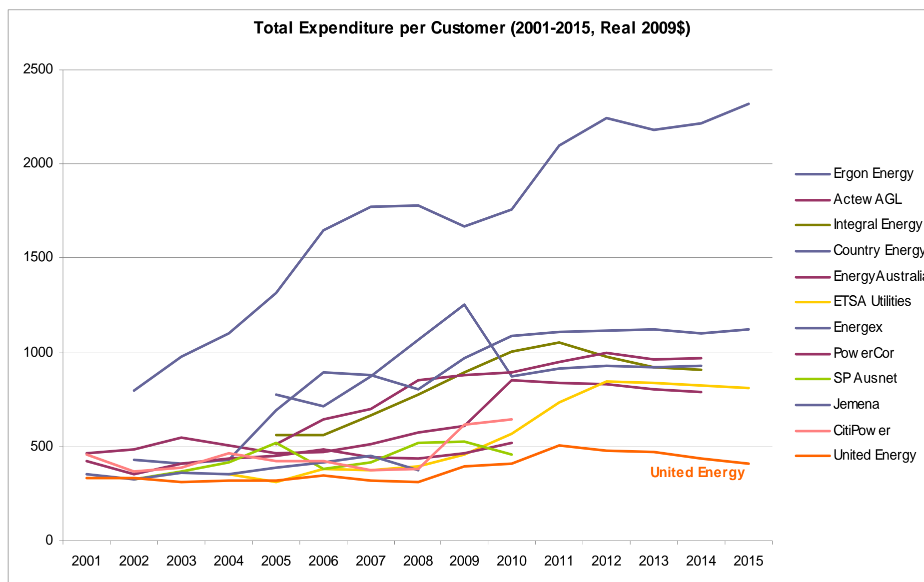
1.2 To provide context for this submission, it is noted that:

- UE provides electricity distribution services to almost 630,000 customers in south-east Melbourne and the Mornington Peninsula; and
- MG provides gas distribution services to more than 665,000 customers throughout the southern and eastern areas of Melbourne, Yarra Ranges and South Gippsland Towns.

1.3 Both companies have responded very positively to incentive regulation since they were established in 1995 and 1997 respectively. Successive price reviews have delivered price and service outcomes for customers that compare favourably with national and international benchmarks. There is no doubt that well-designed incentive-based regulation is capable of delivering excellent outcomes for customers.

1.4 Information submitted by UE and MG in our most recent price review submissions provides ample evidence to illustrate their superior cost and service performance. Figure 1 shows that whilst costs have drifted upwards for a number of distributors, UE has maintained its position as a low cost performer. Figure 2 shows that MG has worked hard to keep ahead of the increasingly tougher cost targets set by the regulator at successive price reviews. This is supported by analysis that shows UE as the most efficient electricity distributor in the country.

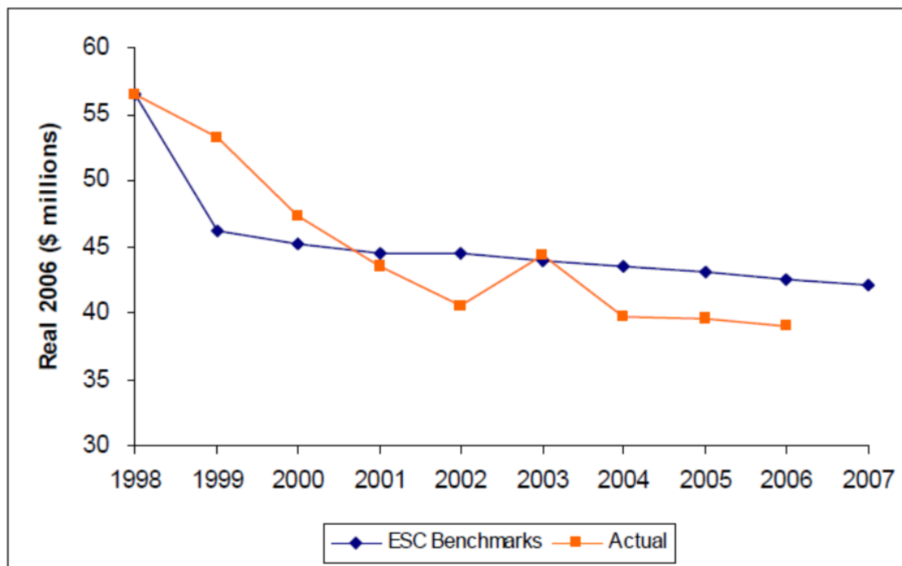
Figure 1: Comparison of total expenditure per customer for electricity distribution companies[1]



1 UE, Regulatory Proposal for Distribution Prices and Services January 2011–December 2015, page 10.

UNITED ENERGY GAS Multinet

Figure 2: MG's operating cost performance relative to the ESC's benchmarks[2]



1.5 Given our superior performance, UE and MG have consistently argued that regulators should consider industry benchmarks when setting price controls. Our experience, however, is that regulators have been reluctant to set prices according to industry benchmarks for the best performing companies. Instead, the approach has been one of expecting more savings from the best performing companies, which is contrary to the competitive market standard that regulation is supposed to mirror.

1.6 Benchmarking is an effective means of regulating network businesses. You would expect that efficient performers such as UE and MG would support benchmarking however it must be capable of producing 'winners' and 'losers' in much the same way as a competitive market. Our experience, however, is that regulators have been reluctant to allow companies to benefit from benchmarking. The AER's proposal that it should have discretion to apply benchmarking in setting expenditure forecasts provides no assurance that the regime will provide positive incentives to deliver efficiency improvements. Ultimately, the discretionary benchmarking proposed by the AER will not deliver long term benefits to customers.

1.7 As discussed in further detail in this submission, the Rule change proposals submitted by the AER and the EURCC breach some important principles of incentive regulation. A particular point of concern is that the AER is adopting a more intrusive approach in which it proposes to take responsibility for expenditure forecasting. Professor Stephen Littlechild, the original architect of CPI-X regulation, has recently cautioned against this approach[3]:

> "Originally, price cap regulation invited the company to discover the most efficient products and methods of production. Now, the regulator is required or presumed to know the answers, which the company is then encouraged to replicate. Regulation has neglected the discovery process."

[2] (MG), Gas Access Arrangement Information, 30 March 2007, page 20.

[3] Stephen Littlechild, Regulation, over-regulation and some alternative approaches, October 2009, page 3.

1.8 The AER acknowledges that they have a lack of understanding of the spending needs of distribution businesses. This acknowledgement coupled with a wide discretion to disregard the plans and forecasts put forward by the businesses is a recipe for significant regulatory failure.

1.9 UE and MG acknowledge that the WACC has been contentious over the last few years. This is not surprising given:

- WACC drives a major proportion of network prices
- There has been a global financial crisis that has made debt and equity raising difficult and has made the WACC parameters volatile
- The AER has been found to have made significant errors in its WACC determinations

UE and Mg do not share the AER's concern about 'constant review' of the WACC. Concerns of 'constant review should not be a justification to remove scrutiny or to seek administrative ease

1.10 The WACC changes proposed by the AER will provide the AER with too much discretion and remove the businesses ability to have merits review. As demonstrated in this submission the AER has made a number of errors in relation to WACC that required correction by the ACT. Providing the AER with more discretion does not provide investors with any confidence that the regime will be improved nor will it provide any additional certainty or stability. Ultimately this will increase the risk of the businesses and the cost of capital.

1.11 As discussed in further detail below, UE and MG do not believe that the Rule change proposals have given sufficient consideration to the objectives in the National Gas Law and the National Electricity Law:

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

1.12 The National Gas Objective and the National Electricity Objective provide the cornerstone of the regulatory framework. Not only do they guide the AER in performing its duties, but they also provide the framework against which Rule change proposals must be assessed by the Commission.

1.13 The objectives recognise the central importance of efficient investment in promoting the long term interests of consumers. As explained in further detail below, while the AER and the EURCC may genuinely regard their proposed changes as desirable, it is evident that practically all of the proposed changes will fail to promote the achievement of the objectives specified in the law. Furthermore, a number of the proposed changes will undermine the incentives for efficient investment.

1.14 The remainder of this submission focuses on the key elements of the proposals presented by the AER and the EURCC. Wherever possible we have provided evidence to support our submission,

although we note that the Rule change process is one in which the case for change must be established by the proponents.

1.15 Before turning to examine the Rule change proposals in detail, we wish to emphasise the importance of consistent and predictable regulatory decision-making in ensuring that sufficient capital continues to be available for investment in regulated infrastructure. In this context we note that during the recent Victorian electricity distribution price review, UE experienced difficulty in finalising a private placement of debt to US investors. The difficulty stemmed from investor perceptions of an unduly aggressive draft decision[4]. UE's experience provides clear evidence of the ease with which capital markets can be unnerved by unpredictable regulatory decision making.

1.16 In a similar vein, frequent or unwarranted changes to the Rules governing regulatory decision making can unsettle investors, leading to funding difficulties and increases in the cost of capital. In this context, it is noted that changes to the National Gas Rules have been proposed even though the Rules have not yet been applied in a Victorian gas access arrangement review. The Commission's assessment of these proposals will need to be cognisant of the potential for perceptions of heightened regulatory risk to lead to outcomes that are detrimental to the long term interests of consumers.

[4] The Draft Decision proposed an initial price reduction for UE of 19.6%, followed by modest annual price rises in the range of zero to 5% for the regulatory period.

2 Proposed changes to the framework for expenditure forecasts

2.1 The AER makes the following criticism of the existing arrangements for establishing efficient and prudent expenditure forecasts:

> "The current framework goes beyond affording a reasonable opportunity to recover efficient costs. Indeed, it invites upwardly biased expenditure forecasts and provides the regulator with limited ability to interrogate and amend forecasts proposed by NSPs." [5]

> "The rules currently require the AER to accept proposals from NSPs if it is satisfied they 'reasonably reflect' efficient, prudent and realistic expenditure. The expression 'reasonably reflects' recognises that there may be more than one expenditure forecast that is efficient, prudent and realistic. Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to prove that the proposed forecast does not reasonably reflect prudent and efficient costs. Even if there is a lower possible forecast that is efficient, prudent and realistic, the rules operate to exclude the AER from setting that lower forecast. In an unbiased regime, all answers that meet the requirements of the NEL could be determined. That is not the case under the current rules." [6]

2.2 The AER also argues that the Rules limit its approach to reviewing the expenditure forecasts proposed by the NSP:

> "As most proposals are based on a large amount of engineering detail and a 'bottom up' calculation of the required expenditure, the AER must conduct a line by line analysis in order to reduce the forecast to fall back within the 'reasonable' range. This inappropriately limits the AER's ability to weigh up all available data and determine an impartial forecast. While a line by line assessment of a limited sample of projects would be undertaken in any well functioning regime, it should not be to the exclusion of other 'top down' techniques, like benchmarking."[7]

2.3 The AER's proposed solution to address its concerns has three components:

- Amend the decision-making test. The AER proposes that it should determine the expenditure forecasts that it considers a prudent and efficient NSP would require to provide a safe and reliable electricity service.

- Amend the factors that the AER must consider in assessing the distributors' expenditure proposals. The AER proposes that it should be required to consider these factors in determining the expenditure forecasts. The AER also proposes to delete clauses 6.5.6(1) and (2), which currently require the AER to consider the information contained in the distributor's regulatory proposal and the submissions received during the course of the consultation process.

- Manage uncertainty in determining capital expenditure forecasts. The AER proposes that contingent projects, re-opener provisions and pass through provisions should be introduced or amended. The purpose of these changes is to allow the regulatory capital expenditure allowance to be increased if this becomes necessary.

2.4 In assessing the AER's proposed changes to the framework for expenditure forecasts, the first step is to examine the AER's criticism of the existing arrangements. The AER complains that the

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5 AER, Rule change proposal, September 2011, page 13.

6 Ibid, page 13.

7 Ibid, page 13.

forecasts are 'upwardly biased'. However, the AER's Rule change submission also complains that a number of distributors are overspending against the regulatory allowance:

> "In the transition to the new framework, several NSPs spent significantly more in the previous period than was allowed in the corresponding determinations (particularly some DNSPs in Queensland and NSW). For example between 2004–05 and 2007–08, the NSW DNSPs spent 19 per cent more than the forecasts set in previous determinations (Figure 1.6). Around 94 per cent of the total overspend was due to expenditure by AusGrid and Essential Energy."[8]

2.6 It is difficult to sustain a logical proposition that expenditure forecasts are both upwardly biased and systematically less than actual capital expenditure. It is more logical to conclude that companies that have overspent against the regulatory allowance found that allowance to be too low. It is self-evident that the allowance was not 'upwardly biased'.

2.7 Conversely, evidence of underspending against the regulatory allowance is not proof of an upwardly biased forecast. This is because:

- A central purpose of incentive regulation is to encourage cost and service performance that is superior to the regulator's forecasts; and
- Capital markets require privatised companies to manage expenditure within the budgets set by the AER.

2.8 The AER's claim that expenditure forecasts are upwardly biased even though the Rules are structured to provide incentives for accurate forecasting (i.e. by disadvantaging the firm if the forecasts are found to be inconsistent with the Rules) and require company directors and the CEO to certify that the key assumptions underlying the expenditure forecasts are reasonable (S6.1.1(5) and S6.1.2(6)). In accordance with the Rules requirements, company directors provide a statutory declaration that attests to the reasonableness of the expenditure forecasts. It is surprising that such an important provision in the existing Rules is not mentioned in the AER's submission. The AER should have confidence in the statutory declarations by company directors and the reasonableness of the forecasts submitted.

2.9 The AER proposes that it should be able to ignore the businesses forecasts and determine the expenditure forecast, rather than assess the forecast proposed by the company. In reaching this conclusion, the AER explains that there are a multitude of "efficient forecasts" and that a line by line assessment of the company's proposals is excessively complex:

> "Of any number of possible forecasts, this effectively allows network businesses to propose the highest possible forecast and leaves the evidentiary burden on the AER to prove that the proposed forecast does not reasonably reflect prudent and efficient costs."[9]
>
> "As most proposals are based on a large amount of engineering detail and a 'bottom up' calculation of the required expenditure, the AER must conduct a line by line analysis in order to reduce the forecast to fall back within the 'reasonable' range. This inappropriately limits the AER's ability to weigh up all available data and determine an impartial forecast."[10]

[8] Ibid, page 10.

[9] Ibid, page 13.

[10] Ibid, page 13.

2.10 Contrary to supporting the AER's proposal for change, the AER's observations explain why its proposals should not be accepted by the Commission.

- Firstly, it is accepted that judgment must be exercised in determining the expenditure forecasts. However, the current Rules recognise that the company, not the regulator, is in the best position to exercise this judgement. The AER's proposal confuses the role of the regulator with the role of the company executives. Compliance obligations cannot reasonably reside with the company if the expenditure decisions are being made by the AER.

- Secondly, the AER's proposal that it should determine the expenditure forecasts will be an extremely onerous task, assuming that it is properly undertaken. The AER's concern that a line by line review of the company's forecast is too onerous is inconsistent with its proposal that it should be wholly responsible for determining the forecasts.

2.11 The third aspect of the AER's proposal is that the capital expenditure forecasts should be capable of being reopened. It is reasonable to infer from this proposal one or more of the following observations:

- The AER is concerned that companies may be unreasonably exposed to non-compliance in circumstances where the forecast capital expenditure has been set by the AER

- The AER is intending to take a 'top down' approach to capital expenditure forecasting which is inherently more risky than the company's current forecasting approach.

- The AER realises that it may inadvertently determine capital expenditure forecasts that are too low and must be corrected during the regulatory period.

- The AER may consciously adopt 'low' capital expenditure forecasts in the knowledge that problems arising may be corrected through re-openers.

2.12 This aspect of the AER's proposal is best regarded as 'a band aid' to deal with the inherent difficulties that would arise if the AER determined the expenditure forecasts. The proposals themselves have not been carefully considered. In particular:

- The concept of contingent projects has been borrowed from the electricity transmission sector, but it is not applicable to distribution networks which undertake thousands of individual projects, many of which could not be defined in the price review process. It would be impractical to re-open a distribution expenditure forecast on the basis that there is a demonstrable need to include additional projects.

- The process for re-opening a distribution determination will create additional administrative costs and project delays. The AER's Rule change proposal allows up to 100 business days after the lodging of an application to make its decision. A delay in project approval of this duration may impose significant costs on customers, and would be a direct consequence of the AER taking responsibility for capital expenditure forecasting.

- The AER has not addressed the risk that it may under-forecast operating expenditure, despite the potentially detrimental impact that under-forecasting operating expenditure would have on maintenance and service performance.

2.13 In assessing the AER's proposal, the Commission is required to consider whether the proposal is likely to further the National Electricity Objective and National Gas Objective. As discussed in

section 1 of this submission, the objective is to 'promote efficient investment for the long term interests of consumers.'

2.14 The Commission must also have regard to the revenue and pricing principles (set out in section 7A of the National Electricity Law, and section 24 of the National Gas Law). Those principles require, among other things, that:

- a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in providing regulated services; and
- regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider.

2.15 These principles recognise the potentially high social cost that may arise when regulatory error (in the form of unreasonably low expenditure allowances) creates disincentives for investment. Insufficient infrastructure investment is inconsistent with promoting the long term interests of consumers.

2.16 UE and MG submit that the AER's proposal in relation to the expenditure framework will not promote efficient network investment for the following reasons:

- The AER's concerns regarding the current Rules are without foundation. The current Rules are consistent with promoting efficient network investment.
- The AER is not equipped to determine efficient network investment. The AER's proposal would usurp the role of the executive management and board. In contrast, the existing Rules appropriately provide the AER with the role of reviewing the forecasts submitted by the companies.
- The AER's proposals expose customers to an increased risk that the expenditure forecasts will be set below the efficient level, contrary to the requirements of the objectives, and the revenue and pricing principles set out in the law. The AER's remedies for addressing these risks will not be effective. For example, 100 business days for a re-opener determination is impractical and, as noted above, may impose substantial costs on customers.
- The AER's proposals will substantially increase regulatory risk and make it more difficult to attract funding from capital markets. The AER's view that it should be no longer obliged to consider the company's proposal or stakeholder submissions is of particular concern.

2.17 The tension between imposing restrictions on the regulator's discretion in order to address the potential for error and the desirability (in terms of meeting the wider objectives of regulation) of leaving decisions to the regulator was a key consideration of the report of the Expert Panel on Energy Access Pricing[11]. The Expert Panel's report also provided a detailed assessment of aspects of the propose-respond model of regulation, which formed a foundation of the Rules that are currently in place. In view of the analysis set out in the preceding paragraphs, UE and MG consider that the matters identified by the AER do not justify the Rule changes sought by the

[11] Expert Panel on Energy Access Pricing, *Report to the Ministerial Council on Energy*, April 2006.

AER, but rather they point to a need for additional resources to be provided to the AER to enable it to execute its powers and functions under the existing Rules effectively and efficiently.

3 Capital expenditure incentives

3.1 The AER's submission expresses concern that the current rules may not provide sufficiently strong incentives to ensure that only efficient investment occurs. The AER comments that this is particularly an issue where the regulated cost of capital is higher than the actual cost of capital for the NSP, or where the NSP is responding to a broader range of incentives, rather than just financial incentives.[12]

3.2 To illustrate its concerns, the AER presents analysis that examines the relationship between the regulated and actual cost of capital and the timing of investment over the 5 year regulatory period. The AER's analysis leads it to the following conclusion:

> "In the event that the true cost of capital is less than the regulated WACC, the current RAB roll forward mechanism rewards network businesses for overspending their capex forecasts during the latter stages of the regulatory control period. For instance, with a true cost of capital of 8 per cent [assuming that the regulated WACC is 11 per cent] and a 40 year asset life, a network business that overspends during the fifth year of the control period would receive payments equal to 26 per cent more than the initial cost of the asset over the remaining life of the asset."[13]

3.3 The AER's proposed Rule change to address the above issue is described in the following terms:

> "The proposed rules amend the RAB roll forward mechanism such that only capex up to the forecast would be automatically added to the RAB. Any expenditure in excess of the forecast would be subject to a 40/60 sharing factor. Under this approach, 40 per cent of capex in excess of forecast would be funded by shareholders and the remaining 60 per cent would be borne by customers via an adjustment to the RAB at the time of the next network determination."[14]
>
> "The proposed rules strengthen the capex incentive framework. Under the AER's proposal, NSPs would have a strong incentive to avoid overspends since they would fund at least 40 per cent of any capex overspend."[15]

3.4 The AER argues that its proposed capital expenditure incentive arrangement will contribute to the achievement of the National Electricity Objective as follows:

> "...the proposed overspend sharing mechanism establishes incentives on NSPs to invest only when it is efficient and prudent to do so. By increasing the level of discipline on capex in excess of forecasts, the proposal contributes to the NEO by reducing unnecessary upward pressure on customer prices."[16]

3.5 UE and MG notes that the AER's analysis of the current incentives to overspend in the final year of the regulatory period is based on two unrealistic assumptions that would never be accepted by senior management or a company board:

- The regulated cost of capital is 11 per cent compared to the actual cost of capital of 8 per cent; and

[12] Ibid, page 38.

[13] Ibid, page 40.

[14] Ibid, page 40.

[15] Ibid, page 42.

[16] Ibid, page 62.

- The assumed difference between the regulated and actual cost of capital will persist over the 40 year life of the asset, which is 8 successive regulatory periods.

3.6 As commercially-driven organisations, UE and MG would never intentionally ‘overspend’ capital expenditure. As a practical matter, planning and governance arrangements that are focused on cost efficiency cannot simply be ‘turned off’ towards the end of a regulatory period in order to respond to a perverse regulatory incentive, even if one did exist. In any event, a commercial case that is predicated on an assumption that the AER will consistently over-estimate the WACC by 300 basis points for 8 successive regulatory periods would not be entertained by staff, the executive team or the board.

3.7 The AER’s proposed solution to its perceived incentive issue (which is not substantiated) is to create a very powerful incentive not to overspend the capital expenditure allowance. Specifically, the AER proposes that only 60% of any overspend can be rolled into the RAB and recovered from customers.

3.8 The practical impact of the AER’s proposed solution is that company boards will be very reluctant to sanction any capital expenditure above the regulator’s allowance. Therefore, the AER’s proposal will fail to promote efficient network investment because it precludes any efficient investment above the forecast amount. The AER’s proposed solution is a disproportionate response to an ill-founded concern.

3.9 To some extent the AER recognises the need to soften its 60/40 rule by proposing re-opener and contingent project provisions to accommodate circumstances where overspending would be efficient. It is the same ‘band aid’ solution discussed earlier, where poorly designed regulation requires another layer of regulation to manage the risk of adverse outcomes.

3.10 While the AER’s proposed changes may be well-intentioned, the changes are more likely to cause inefficiently low capital expenditure. A better approach would be to create stronger incentives for capital expenditure efficiency improvements, possibly through the extension of the Efficiency Benefit Sharing Scheme to capital expenditure.

3.11 UE and MG submit that the AER’s proposal in relation to capital expenditure incentives will not promote efficient network investment for the following reasons:

- The theoretical incentive to overspend capital expenditure in the later years of a regulatory period does not exist in practice.
- The AER’s proposal will prevent companies from incurring any capital expenditure above the AER’s forecasts, even when it would be efficient to do so.
- The AER’s solutions to the problems stemming from the regulator setting an inefficiently low capital expenditure allowance will add an unnecessary layer of additional regulation.

4 Excluding related party margins from the RAB

4.1 The AER comments that there are circumstances where margins paid by the NSPs to their related parties do not reasonably reflect efficient costs and are excluded from the forecast expenditure.

4.2 The AER is concerned that the existing Rules allow related party margins in capital expenditure to be rolled into the RAB, in circumstances where the margins have been disallowed in the forecast capital expenditure.

4.3 The AER describes its proposed Rule change in the following terms:

> "This rule change proposal ensures that, if the AER determines a margin or portion of a margin is found to be inefficient and therefore excluded from forecast expenditure, such margins would be treated on a consistent basis and excluded from the RAB when actual expenditures are accounted for at the end of the regulatory control period. Similarly, this proposal will remove any perverse incentives for NSPs to change their approaches to capitalising overheads during a regulatory control period in order to roll in higher amounts of capitalised overheads into the RAB at the end of the regulatory control period."[17]

4.4 UE and MG do not accept the AER's proposition that the approach adopted in relation to forecast capital expenditure should necessarily determine the treatment of related party margins when capital expenditure is rolled into the RAB. A company's contractual arrangements may change during a 5 year regulatory period. The case for excluding or including related party margins may also change over that period. Therefore, it is better to treat the case for including or excluding related party margins from the RAB on its merits at the time of the decision.

4.5 More generally, UE and MG have concluded that related party contracts have become untenable from a regulatory perspective, even in circumstances where the related party is demonstrably the most efficient service provider. As such we have responded to the regulatory pressure and sought to exit existing related party contracts. The AER's Rule change proposal is a timely reminder that related party margins should be examined on their merits. It is not appropriate for the Rules to adopt a fixed view that has no regard to the particular circumstances of the network service provider.

4.6 UE and MG submit that the AER's proposal regarding related party margins will not promote efficient network investment for the following reasons:

- Efficient capital expenditure may include the payments of a margin to a related party.
- The AER's rule change proposal would treat all future related party payments as either efficient or inefficient on the basis of forecast information.
- By prejudging the treatment of actual payments to related parties, the AER's proposal may either inadvertently remunerate inefficient capital expenditure or penalise companies that have achieved efficiency improvements. Both outcomes would be inconsistent with the National Electricity Objective.

[17] Ibid, page 53.

5 Introducing new incentive schemes

5.1 The AER notes that incentive schemes are an important part of the regulatory toolkit and the framework should be sufficiently flexible to respond to developments in regulatory best practice.

5.2 The AER is concerned that the existing Rule is overly costly:

> "In order for a new incentive scheme to be applied to NSPs under the current rules, a full rule change process would need to be conducted. This process imposes significant costs on all interested stakeholders. The AER considers that it is an overly costly process to incrementally develop the regulatory regime in order to keep pace with international best practice." [18]

5.3 Under the proposed rules, the AER would be able to develop and publish other incentive schemes beyond the EBSS, STPIS and DMIS, subject to the any such incentive scheme meeting the following principles:

- the benefits to consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme;
- In developing a new scheme, the AER must have regard to:
  - possible effects of the scheme on incentives for the implementation of non network alternatives;
  - the need to ensure that the incentives are sufficient to offset any financial incentives the NSPs may have to reduce costs at the expense of service levels;
  - the willingness of the customer or end user to pay for increases resulting from implementation of the scheme; and
  - ensuring that financial or non-financial targets and service standards set by the scheme do not put the safe and reliable operation of the electricity transmission or distribution networks at risk.

5.4 UE and MG note that the AER's proposal runs the risk of blurring the distinction between 'rule maker', which is the role of the Commission; and 'rule enforcer', which is the role of the AER. Furthermore, it is unclear why the AER's consultation process for introducing a new incentive scheme should be any less onerous than the Commission's consultation process for a Rule change proposal.

5.5 In light of the comments above, it is highly doubtful whether the AER's proposal would further the achievement of the National Electricity Objective or the National Gas Objective. It is also noteworthy that the AER has not reflected these objectives in the principles that it proposes to adopt in relation to new incentive arrangements. This omission strengthens our view that the proposed changes should not be accepted by the Commission.

[18] Ibid, page 56.

6 Treatment of shared assets

6.1 The AER raises the following concerns in relation to the treatment of 'shared assets':

> "The current rules do not allow the AER to make a revenue adjustment for the use of standard control assets in the provision of other services, including unregulated services. This results in standard control service customers paying for 100 per cent of the costs of an asset, but receiving no compensation when the same asset is used by the service provider in undertaking other activities." [19]

6.2 The proposed Rules would enable the AER to include a 'revenue decrement' in the building block calculation for standard control services:

> "arising from the use or forecast use of assets forming part of the regulatory asset base for the provision of services other than the provision of standard control."[20]

6.3 The AER explains that its proposed Rule would enable the AER to adopt a range of approaches to capture revenue from non-regulated activities:

> "Revenue adjustments would be preferable where reasonable forecasts of use can be made. In such circumstances, smoother prices could be obtained by including an ex ante revenue adjustment in the building blocks calculation. A control mechanism adjustment (for example, a profit share mechanism) would be preferable where the benefits derived from, and use of, the shared assets for other purposes involves significant uncertainty and therefore forecasting a reasonable revenue adjustment is problematic (if not impossible). In such circumstances the AER would seek to set the incentives on an ex ante basis (for example, the AER could state that a certain proportion of pre-tax profits from these other activities should be shared with users) but would only make the revenue adjustment ex post, such as during the annual price approval process." [21]

6.4 The AER also acknowledges that the issue of non-regulated activities was addressed by both the Commission and the MCE in developing the Chapter 6A and Chapter 6 Rules. The AER explains the views of the Commission and the MCE in the following terms:

> "In developing chapter 6A, the AEMC indicated that it understood that no assets used for unregulated services would form part of the opening RABs which were based on previous jurisdictional valuations. The MCE adopted the same approach to codifying the opening RABs in chapter 6, though it does not appear the MCE intended this to result in standard control customers paying 100 per cent of the cost of assets used for regulated and unregulated activities. Rather, it appears the MCE considered this issue could be addressed through cost allocation. In response to a stakeholder submission on this issue, the MCE stated:
>
> *'The standard practice will be for the unregulated portion of the asset to be excluded from the regulatory asset base, which currently cover standard control services. [MCE SCO] considers that this process is appropriate for the purposes of cost allocation. The transitional arrangement for Queensland distribution businesses will appropriately address this.' [SCO response to stakeholder comments on the Exposure Draft of the National Electricity Rules for distribution revenue and pricing (Chapter 6), page 15].*
>
> The current cost allocation method (CAM) approach does not apply to non distribution services. Further, addressing this issue through a cost allocation approach could only apply to future assets not

[19] Ibid, page 59.

[20] AER proposed clause 6.4.3(a)(8).

[21] AER, Rule change proposal, September 2011, pages 60 and 61.

existing assets. Finally, while a CAM assists in preventing users paying costs associated with the provision of non-standard control services, it does not allow users to share in any benefits from standard control assets being used for other purposes."[22]

6.5 The AER claims that the proposed Rule change will contribute to the achievement of the National Electricity Objective by:

> "allow[ing] consumers, as well as NSPs, to benefit from the use of regulated assets for non-regulated purposes." [23]

6.6 In examining the AER's proposed Rule change, it is useful to revisit the Commission's comments in determining the Chapter 6A rule, which the AER alluded to in its Rule change submission:

> "The Commission's understanding is that the RAB established for each TNSP does not reflect the value of assets associated with negotiated or unregulated services. Where assets are used to provide contestable services or non-contestable services under a negotiated contractual arrangement, the existing Rules do not allow revenue in relation to those assets to be recovered via the annual average revenue requirement (AARR), and they are not included in the RAB. This is also reflected in the current practice of TNSPs.
>
> Given the Commission's understanding of current practice, locking in the current RAB values for the TNSPs is consistent with the approach proposed in the Rules to only include the value of assets associated with prescribed transmission services in the RAB, since these initial values should not include assets associated with negotiated or unregulated services.
>
> The Commission's decision is that the Draft Rule approach to specifying the initial RAB values is appropriate. The values have undergone considerable scrutiny by the ACCC at each of the previous regulatory reviews. The risks (and thereby costs) associated with these initial values containing errors is therefore low, and likely to be outweighed by the benefits associated with specifying the initial RAB values in the Rule at this time."24

6.7 It is evident from the above quotation that the Commission rejected the proposition that the value of the regulated asset base should be revisited. There are sound economic reasons that underpin the Commission's conclusions:

- The incentive to invest will be substantially undermined if network companies are exposed to the risk that the regulator may reduce the value of its assets at some future time; and
- Investors will require a higher cost of capital if assets are subject to the risk of stranding. This higher cost of capital will translate into higher costs to customers.

6.8 It is evident from the AER's proposed Rule change that the effect of the AER's proposal is identical to removing assets from the regulated asset base. As noted above, the AER has raised the following concerns that relate specifically to the value of the existing regulated assets:

> "This results in standard control service customers paying for 100 per cent of the costs of an asset, but receiving no compensation when the same asset is used by the service provider in undertaking other activities."
>
> "...addressing this issue through a cost allocation approach could only apply to future assets not existing assets."

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22 Ibid, page 61.

23 Ibid, page 63.

24 AEMC, Final Determination, National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18, 16 November 2006, page 76.

6.9 The AER's intention is effectively to transfer the value of existing assets out of the RAB and into non-regulated activities. This outcome, however, is achieved 'through the backdoor' by applying a 'regulatory tax' to revenue generated by non-regulated activities. It is proposed that the proceeds from this tax are used to diminish the cost of the regulated asset base.

6.10 Superficially, it could be argued that the AER's proposal should be permissible because it simply allows the customers that have 'paid for' the regulated assets to benefit from non-regulated revenue streams. There are, however, two important deficiencies with this proposition:

- It is shareholders that have 'paid for' the regulated assets, not customers. The value that shareholders have paid for the regulated assets reflects the expected net earnings from non-regulated activities. The AER's proposal would transfer value from shareholders to customers, and would have a detrimental impact on future investment incentives.

- It is reasonable for distribution network prices to be insulated from the profits and losses in non-regulated activities. Without this ring-fencing, the AER is re-drawing the boundaries between regulated and non-regulated services.

6.11 UE and MG submit that the AER's proposal in relation to shared assets will not promote efficient network investment for the following reasons:

- It is tantamount to revisiting the value of the regulated asset base, although it achieves this outcome through revenue transfers.

- The transfer of value from shareholders to customers heightens regulatory risk, which will have a strongly negative impact on future investment.

- It will strongly discourage network companies from investing in non-regulated activities, as revenues from these activities will be exposed to a 'regulatory tax', which is both unwarranted and ill-defined.

- The imposition of a tax on non-regulated revenues cannot promote incentives to invest in network services for the long term benefit of customers. It therefore cannot be considered to contribute to the achievement of the National Gas Objective or the National Electricity Objective.

7 Determination of the rate of return

7.1 The AER explains that the current arrangements under the National Electricity Rules in relation to the determination of the WACC differ between electricity distribution and transmission. In particular, while both chapters 6 and 6A require periodic 'WACC reviews', chapter 6 requires the outcomes of such reviews to be published in a statement of regulatory intent (SORI) which can be departed from in each distribution determination in the presence of 'persuasive evidence'. Conversely, in chapter 6A, WACC review outcomes cannot be departed from in transmission determinations. The SORI does not apply to the regulation of gas networks.

7.2 The AER argues that there appears to be little justification for having different arrangements in setting the WACC for electricity DNSPs and TNSPs and gas networks. The AER notes that the WACC is a benchmark and is largely independent of business / industry specific considerations.

7.3 In choosing between the different WACC provisions, the AER makes particular criticisms of the existing arrangements for electricity distribution:

> "For many parameters, the current rule framework in chapter 6 provides for the AER and DNSPs to be in continual 'WACC review' mode where considerable resources are spent at every determination process re-examining issues. The incentive for DNSPs to argue with the AER has also resulted in reviews by the Australian Competition Tribunal in pursuing a level of precision which can only be considered spurious in the context of many WACC parameters. Moreover, where the AER has undertaken a thorough review in the context of chapter 6A and made an overall decision which reflects the views and interests of all stakeholders, it remains open for DNSPs to cherry pick those component parameters of the WACC which they consider unfavourable for them. This process detracts from the AER's ability to adequately consider the resulting overall rate of return." [25]

7.4 The AER has also pointed to specific concerns relating to the estimation of the debt risk premium:

> "The restrictive nature of this DRP definition has resulted in significant debate and merits review processes that have focussed on technical arguments around an appropriate choice of data to satisfy the benchmark definition rather than how best to achieve outcomes that are in the long term interests of consumers." [26]
>
> "If the AER were to set its DRP at levels closer to the electricity networks' current actual cost of borrowing, resulting in a conservative reduction in approved margins of, say, 1 per cent, this would result in consumers paying approximately $400 million less to electricity networks in 2011, with this saving increasing in line with additional investments in new assets each year." [27]

7.5 The AER proposes the following Rule changes:

- periodic 'WACC reviews' would be conducted, the outcomes of which cannot be departed from in subsequent regulatory determinations (as per the current arrangements for TNSPs);
- no 'persuasive evidence' test would apply at the time of each WACC review; rather, the AER would be required to have regard to previously adopted values in tandem with all other NER and NEL requirements, instead of being potentially bound to previous values;

[25] AER, Rule change proposal, September 2011, page 65.

[26] Ibid, page 65.

[27] Ibid, pages 65 and 66.

- the scope of the WACC review would be widened to cover the methodology for setting the DRP; and
- provisions relating to the timing of WACC reviews across chapter 6 and 6A would be aligned, allowing AER to initiate reviews before the expiry of a five year interval (as per the current arrangements for DNSPs). [28]

7.6 Before turning to the detail of the AER's proposal, it is essential to reiterate the importance of setting an appropriate WACC in the context of promoting the National Electricity Objective and National Gas Objective. Specifically, if the WACC is set too low, efficient network investment will not occur because capital markets will not provide the necessary funding. Therefore, while it is tempting to view the WACC as an area where the AER can make 'easy savings' on behalf of customers, the longer term investment and performance consequences of such an approach are highly undesirable.

7.7 The changes proposed by the AER will provide the AER with too much discretion and remove the businesses ability to have merits review. As demonstrated below the AER has made a number of errors in relation to WACC that required correction by the ACT. Providing the AER with more discretion does not provide investors with any confidence that the regime will be improved nor will it provide any additional certainty or stability. Ultimately this will increase the risk of the businesses and the cost of capital.

7.8 The AER expresses concern that it is in continual review mode in relation to the WACC. However, the WACC is the most important parameter in ensuring that investors continue to provide the necessary financial capital to invest in network companies to deliver the services that customers expect. A 'one-size fits all' approach to WACC may have the benefit of reducing the AER's resource requirements, but it runs the risk of determining a WACC that does not reflect the prevailing market conditions. These risks substantially outweigh the resource costs.

7.9 UE and MG acknowledge that the WACC has been contentious over the past few years. This is not surprising given;

- WACC drives a major proportion of network prices;
- There has been a global financial crisis that has made debt and equity raising difficult and has made WACC parameters volatile; and
- The AER has been found to have made significant errors in its WACC determinations

UE and MG therefore do not share the AER's concerns that the WACC is subject to 'constant review'. Concerns of 'constant review' should not be a justification to remove scrutiny or to seek administrative ease.

[28] Ibid, page 66.

7.10 The AER has faced a number of challenges in the Australian Competition Tribunal in relation to WACC. In a number of instances, the Australian Competition Tribunal has found in favour of the companies. The AER characterises these outcomes as the network companies 'cherry-picking' the WACC parameters and, by implication, obtaining an overall WACC that is too generous.

7.11 UE and MG does not agree with the AER's assertion network companies are 'cherry picking' the WACC parameters. It does not seem unreasonable for stakeholders to expect the AER to set all 6 WACC parameters accurately and on an internally consistent basis, rather than setting some elements 'too high' and other elements 'too low'. UE and MG therefore reject the accusation that the companies have been 'cherry-picking'.

7.12 We note that this complaint relates to merits review appeals raised by the businesses and that merits review is outside of this Rule change process. UE and MG note that the ACT has found that the AER has made serious errors in relation to the WACC and has not complied with the Rules. It appears that the AER is seeking to change the Rules so as to provide them with more discretion so as to avoid appeals (i.e. bypass the merits review process) – and uses the guise of 'cherry picking' by the businesses to do this.

7.13 It is also instructive to read the decisions of the Australian Competition Tribunal in assessing whether it is appropriate to provide the AER with greater discretion to set the WACC parameters and to remove the network companies' right of appeal (which is the effect of the AER's proposal). The following extracts are taken from various decisions by the Australian Competition Tribunal:

> "Second, if the AER is to undertake statistical testing in the future, it should reconsider its approach to data interpolation. For instance, the AER assumed that where no observations on yields are recorded, the missing yields are the same as the last recorded observations. This rule has the virtue of simplicity but results in a downward bias in the recorded yields when actual yields are rising and an upward bias when actual yields are falling. The Tribunal notes that there are several better options ranging from a linear interpolation between the bookend observations to a more sophisticated, albeit resource-intensive, investigation into whether the market as a whole moved up or down on a particular day/period or whether there were explanations specific to the individual bond."
>
> "In the course of its reasons [in relation to ActewAGL] the Tribunal made a number of observations, including the following:
>
> (a) The five bonds selected by the AER did not provide a basis for comparison with the fair value curves because the number of bonds was too small and their maturities too short to be sufficiently representative of the yield on 10-year bonds: ActewAGL at [38] - [39];
>
> (b) It was unreasonable for the AER not to include floating rate bonds in its population: ActewAGL at [55];
>
> (c) Floating rate bonds ought to have been taken into account and treated equivalently to fixed rate bonds: ActewAGL at [58]; and
>
> (d) Even if it was reasonable not to include A- and BBB bonds in the population (because they were not representative of BBB+ bonds), it was unreasonable for the AER not to consider whether useful information could be obtained from taking these bonds into account without including them in the population: ActewAGL at [63]"[29]

[29] Australian Competition Tribunal, Application by Jemena Gas Networks (NSW) Ltd (No 5) [2011] ACompT 10 (9 June 2011), paragraph 11.

7.14 In an appeal brought by Energex Limited (in relation to gamma, the value of which is set by the AER through its WACC review process) the Australian Competition Tribunal's determination commented:

> "How then did the AER make its error of logic? The relevant upper bound from the Handley and Maheswaran (2008) tax statistics study was that for the post-July 2000 period. This is the period during which franking credits have been able to be used in full, even if they exceed the investor's tax payable, through their provision as a rebate. This aspect of the tax law is still current and hence applies to the task of estimating theta and gamma for the purposes of the Rules. It could be expected to result in higher utilisation rates than heretofore. The Handley and Maheswaran (2008) estimate for the period was 0.81.
>
> The AER, recognising that this was an upper bound on the value of theta for the relevant period, decided to be "conservative" by adjusting the figure downwards. As explained, it did so by averaging 0.81 with the lower figure of 0.67 that Handley and Maheswaran (2008) estimated for the period 1988-2000.
>
> But this simple averaging adjustment has no logic to it and fails to accord each Handley and Maheswaran (2008) estimate its correct interpretation as an upper bound applying to a period. The fact that the AER chose a simple average rather than using the Handley and Maheswaran (2008) estimate for the combined period 1988-2004 is immaterial to the AER's error, since any downward adjustment to a properly derived upper bound would be inappropriate as a means of deriving an estimate of theta."[30]
>
> "The AER's report raises what it calls major compliance issues – eight in number – with the terms of reference. These all relate to the treatment of the data. The AER also makes comments on SFG's analysis: the model specification and estimation procedures. The AER's overall conclusion is that the SFG report should be considered 'together with the results of other relevant and reliable studies'.
>
> In SFG's April 2011 report and its further supplementary report, SFG responded to the AER's report in considerable detail.
>
> It is not necessary to set out the details of the eight issues, since they raise no important or significant questions of principle. Rather they involve detailed decisions made in the course of constructing a database and analysing it. Having considered the reports, including Officer's April 2011 report, the Tribunal has concluded that any departures from the agreed terms of reference were justified, even necessary. Calling them "major compliance issues" is unnecessarily pejorative. Whether or not the terms of reference have been departed from, what is important is whether the concerns raised by the AER with the construction of the database cast doubt on the value of SFG's analysis, requiring the Tribunal to give it less weight than it otherwise would.
>
> In the Tribunal's view, they do not. The Tribunal is satisfied that the procedures used to select and filter the data were appropriate and do not give rise to any significant bias in the results obtained from the analysis. Nor was that suggested by the AER." [31]

7.15 UE and MG submit that the examples cited from the Australian Competition Tribunal decisions highlight specific cases of errors of logic or approach that needed to be corrected. It should also provide caution that providing the AER with more discretion and limiting access to merits review will lead to greater regulatory uncertainty. Too much discretion provided to the AER does not sit well with investor confidence especially given the current performance and the removal of merits appeal.

7.16 UE and MG consider that providing access to merits review is a fundamental pre-requisite for effective independent regulation because it provides a safeguard to ensure that regulatory

[30] Australian Competition Tribunal, Application by Energex Limited (No 2) [2010] ACompT 7 (13 October 2010), paragraphs 93-95.

[31] Australian Competition Tribunal, Application by Energex Limited (Gamma) (No 5) [2011] ACompT 9 (12 May 2011), paragraphs 16-19.

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decision-making at all times accords with the requirements of the law. The appeal process should therefore be regarded as a normal part of the regulatory regime, rather than evidence of regulatory failure. That said, we consider it is reasonable to expect that the scope and frequency of merits reviews will decline in the future for the following reasons:

- Precedents have now been set (in areas such as the value of gamma, for instance) in the decisions already made by the Tribunal.
- All parties, including the AER are still gaining experience in the interpretation and application of the Rules (which have been in place for only five years).

7.17 UE and MG submit that the AER's proposal in relation to WACC will not promote efficient network investment for the following reasons:

- The regulatory framework should provide network service providers and other stakeholders with the right to propose changes to the WACC parameters if there is persuasive evidence to do so.
- The AER's proposal would 'lock in' WACC parameters even in circumstances where new evidence demonstrated the case for change. This outcome would be contrary to the National Electricity Objective because the 'locked in' WACC parameters may be either inefficiently high or low.
- Recent Australian Competition Tribunal decisions in relation to the WACC illustrate the importance of merits review and the risk of regulatory error. The decisions point to errors by the AER on one or more of the 6 parameters that together determine the WACC and corporate tax allowance.
- The case for increasing regulatory discretion and removing access to merits review has not been established. Such an outcome would increase regulatory risk, contrary to the National Electricity Objective.

8 Debt risk premium – Energy Users Rule Change Committee

8.1 The EURCC proposes changes to the provisions in the National Electricity Rules relating to the estimation of the regulatory allowance for the cost of debt. The EURCC proposes that:

- a guiding principle is that the return on debt, whether for government or privately owned network service providers, should reflect the actual cost of debt;[32]
- separate cost of debt allowances should be made for Government-owned and privately owned electricity networks, because Government-owned entities face a lower cost of debt;
- for privately owned NSPs, the return on debt should be based on an index that reflects fair value estimates of the yield to maturity on investment grade corporate debt issued in Australia;
- the cost of debt allowance should be based on a five year rolling average that is mechanistically updated each year of the regulatory period; and
- the methodology for determining the cost of debt allowance along with the relevant parameters such as debt term and credit rating should be specified in the Rules, rather than being subject to AER review.

8.2 In support of its proposal, the EURCC contends that "there is compelling evidence that privately owned electricity NSPs – who constitute around 25% of the industry (by assets) have a cost of debt that is around 250 basis points lower than the return on debt that they have been allowed to charge users".[33]

8.3 UE and MG consider that the EURCC proposal is ill-founded in a number of respects, for the reasons set out below.

8.4 In relation to the cost of debt allowance for Government-owned NSPs, the EURCC states:

> "The main argument that state governments and their NSPs have used to justify that the return on debt should be equivalent to that awarded to privately owned distributors is that this is necessary to ensure 'competitive neutrality'."[34]
>
> "NSPs are monopolies and as such their captive customers are unable to avail themselves of the services of a competitor. There is no reason to imagine that government owned NSPs are privately owned on the basis of that they cannot crowd-out non-existent competitors. In other words, in the language of the Competition Principles Agreement, there is no "resource allocation distortion problem" to which the application of competitive neutrality principles is a necessary or theoretically valid solution… The logical conclusion from this is that there is no basis in theory or the application of the Competition Principles Agreement that the return on debt of government-owned NSPs should be based on the cost of debt for privately owned NSPs."[35]

[32] EURCC, Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, page 6.

[33] Ibid, page 5.

[34] Ibid, page 30.

[35] Ibid, page 31.

8.5 EURCC's proposal to apply a lower cost of debt to Government owned businesses would breach the important principle of competitive neutrality. Over the long term, such an approach will lead to the emergence of material differences in network charges across the national electricity market. The EURCC incorrectly concludes that breaching this principle has no effect on competition because 'customers are unable to avail themselves of the services of a competitor.'

8.6 In contrast to EURCC's conclusions, new generators and industrial/ commercial loads are able to make locational decisions in response to factors such as network charges. EURCC's proposal will distort network prices and create a competitive advantage for customers and generators in Government owned networks. Over the longer term, sustained distortions in network prices will affect the location decisions of industrial / commercial loads and generation. Transmission and distribution network investment will also be distorted. Economic activity will tend to shift from States with privately owned networks to those with Government ownership. All of these outcomes are contrary to the National Electricity Objective and the purpose of the reforms undertaken in competition policy, and the industry in the 1990s.

8.7 The EURCC's error on the issue of competitive neutrality illustrates that its proposals are focused on the short term consideration of affecting value transfers from networks to customers, rather than seeking to promote the National Electricity Objective. The Commission is required to take the more disciplined approach of focusing on the specific objectives that have been set out in the Law.

8.8 The EURCC's submission seeks to compare a "weighted average margin" on debt issued by privatised NSPs (which it calculates to be 181 basis points) and the debt risk premium determined by the AER (circa 385 basis points).[36] However, the comparison is misleading because the EURCC calculates the 181 basis point margin with reference to the Bank Bill Swap Rate, whereas the AER allowance of 385 basis points is a margin over the (lower) risk free rate.

8.9 The precise impact of the EURCC's erroneous comparison is difficult to assess without undertaking detailed analysis, especially as the global financial crisis led to an unprecedented margin between the Bank Bill Swap Rate and the risk free rate. It does, however, illustrate the importance of ensuring that comparisons are made on a like-for-like basis.

8.10 The EURCC's submission includes a paper from consultants, Cambridge Economic Policy Associates Ltd (CEPA). CEPA's report proposes the following approach for estimating the debt risk premium:

> "Given our considerations we believe that the approach to be adopted for privately owned companies should be one that:
>
> - focuses on remaining five year maturity bond issues;
> - encompasses broad BBB and broad A rated bonds to ensure as large a base of appropriate bonds as possible and which reflects the mix of underlying ratings Australian network companies have and what would be expected over an investment cycle;
> - focuses only on AUD denominated issues; and

[36] EURCC, Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, page 28.

- incorporates historic information through a five year rolling mechanism that is mechanically updated annually."[37]

8.11 UE and MG agree with CEPA that the benchmark should focus only on AUD denominated issues. In addition, the proposal to adopt a five year rolling mechanism is potentially interesting. However, it is noteworthy that CEPA is uncertain on how its proposal should be applied in practice. In its summing up, CEPA concludes that a simple average of Bloomberg's Fair Market Value (FMV) curves for A and BBB rated bonds should be adopted:

> "While our preference would be to have a bespoke index of network bonds, the reality is that there is still insufficient information available to develop this – especially as historic information is limited and at least four years worth of data is needed today if this rule were to be implementable at the next AER price determination. As such, we recommend using a simple average of the Bloomberg FMV A and BBB yields to maturity." [38]

8.12 CEPA offers only the following limited rationale for widening the existing credit rating to include A to BBB rated bonds:

> "Since the GFC the divergence between A and BBB bonds has widened and while it has reduced from the heights reached in 2009, it is still significantly above the impact of being a utility that was observed in the 1990s. However, as noted earlier, we would expect company ratings to move within the range of A and BBB ratings during an investment cycle and consequently a simple averaging would be appropriate." [39]
>
> "Using the broad A and BBB indices for non-financial corporate five year bonds provides the broadest base for calculating the FMV and does not face the problem of "picking" specific bonds for the FMV calculation or having to establish potentially arbitrary criteria for selecting bonds to include. Further, the data limitations mean that even using the full range of bonds does not provide that large a base on which the average yield is being calculated." [40]

8.13 An important concern with CEPA's proposal is that it adopts a wide range of credit ratings from A to BBB. It is questionable whether such a range is consistent with a benchmark approach to setting the WACC where a single set of consistent assumptions are required. For example, gearing assumptions and the value of equity beta must be consistent with the assumed credit rating. A credit rating of A implies a much lower level of gearing than a credit rating of BBB, which in turn implies different values for the equity beta. Inconsistent assumptions across these WACC parameters will not produce a reliable WACC estimate.

8.14 Despite CEPA's conclusion that the debt risk premium for private companies should be based either on a calculated corporate bond index or on the fair market value curves published by Bloomberg, EURCC's proposed Rule makes no mention of using Bloomberg data. Nonetheless, the EURCC clearly states that it accepts and endorses CEPA's recommendations[41]. The definition contained in the Rule proposed by EURCC is as follows:

> "RoD(p)(i) is the Return on Debt issued to private lenders. It is to be calculated as the simple average yield to maturity of A and broad BBB fair market value estimates of corporate bonds issued in Australia over the five year period ending on December 31st of year (i-1)."

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[37] Cambridge Economic Policy Associates, Estimating the debt margin, October 2011, page 31.

[38] Ibid, page 37.

[39] Ibid, page 34.

[40] Ibid, page 34.

[41] EURCC, Proposal to change the National Electricity Rules in respect of the calculation of the Return on Debt, page 43.

8.15 CEPA's conclusion that Bloomberg fair value yield curves should be used does not sit well with the EURCC's criticisms of their use, under the heading "the wrong benchmark has been specified":

> "The benchmark tool used by the AER – the Bloomberg Fair Value curve but using just a small handful of relevant bonds – cannot be accepted uncritically. Jurisdictional regulators (for example the Independent Pricing and Regulatory Tribunal (IPART) in New South Wales and the Economic Regulation Authority (ERAWA) of Western Australia) have rejected. NSPs have also questioned it." [42]
>
> "The distributors themselves – in the context of the regulation for the Advanced Metering Infrastructure roll-out – rejected the use of the benchmark specified in the Rules and argued instead for a benchmark based on a single recently issued bond." [43]
>
> "Both IPART and the ERAWA, following recent reviews, have rejected the use of Bloomberg Fair Value Curves in order to establish the regulated return on debt."[44]

8.16 It is not reasonable for the EURCC to identify the use of the Bloomberg fair value yield curves as an issue to be resolved, but to then, in effect, endorse the continued use of this information. This inconsistency may explain why the use of the Bloomberg proprietary information is not specifically mentioned in the proposed Rule, even though CEPA recommends that some reliance should continue to be placed on Bloomberg fair market value curves. More broadly, given the complexity and potential controversy in estimating the debt risk premium, it is incumbent on a Rule change proponent to propose amendments that minimise uncertainty and ambiguity.

8.17 EURCC's proposal that the debt risk premium is updated annually. The EURCC does not explain how this approach would work in practice, but it does offer a rationale for the proposed change:

> "The most efficient way to design the regulatory algebra to accommodate the change we have proposed, will require further analysis. We have not yet undertaken such analysis but propose to consult with the AEMC to develop an appropriate solution." [45]
>
> "CEPA recommends that the return on debt should be based on a five year rolling mechanism that is mechanistically updated each year of the price control review. This addresses the problem of volatile estimates of debt costs when sampled over a short period of time, and it also addresses the problem of windfall gains and losses that arise when there are differences between the embedded and future costs of debt."[46]

8.18 A closer inspection of CEPA's report indicates that its proposal for updating the debt risk premium annually is based on an Ofgem approach that has yet to be implemented. In contrast to EURCC's assertion, CEPA's assessment of the averaging period issue does not strongly advocate a change to the existing Rules:

> "Over what period should the debt premium be estimated? The focus to date in Australia has been to take an average of 15-20 working days over the recent past to provide an estimate of the premium. This approach is seen to mix the focus on recent information providing the 'best' estimate from an efficient market while accepting that day-to-day volatility may be irrational.
>
> There is no right or wrong answer to the averaging period question. In part it depends on the perceived volatility of a market and in part on the overall approach being adopted. Regulators

[42] Ibid, page 24.

[43] Ibid, pages 24 and 25.

[44] Ibid, page 25.

[45] Ibid, page 53.

[46] Ibid, page 43.

in the UK tend to look at longer historical periods when setting rates – this is especially true with the shift to a 10-year indexed approach being adopted by Ofgem." [47]

8.19 For a Rule change proposal to be accepted by the Commission the proponent must demonstrate that the proposal will promote the achievement of the National Electricity Objective. UE and MG submit that the proposal should not be accepted for the following reasons:

- EURCC is incorrect in rejecting the principles of competitive neutrality. Its proposal will create a long term distortion in network prices that will affect competition in upstream and downstream markets.
- Government owned business do not have a lower WACC once you take into account of the credit support they get from their parent.
- EURCC has not established why a simple average of the A to BBB rated bonds using Bloomberg's Fair Value Market data will better achieve the National Electricity Objective than the existing Rules. Furthermore, it cannot provide consistency in relation to the assumed level of gearing and the value of the equity beta.
- EURCC has not established why an annual updating of the debt risk premium calculation will better achieve the National Electricity Objective. Furthermore, the EURCC has not explained how its proposal would be implemented.

8.20 UE and MG are attracted to some aspects of EURCC's proposal. However, EURCC's Rule change submission highlights the complexity surrounding the estimation of the debt risk premium and the importance of careful analysis and review before change is implemented. For example a wider range of bonds may be plausible providing that an appropriate adjustment is made for the interest rate and margin to fit the benchmarking rating. The AER's scheduled review of the WACC parameters provides the appropriate mechanism for examining change. As noted above, the importance of maintaining merits review for all parties is also an important feature of the existing regulatory framework that should be retained.

[47] Cambridge Economic Policy Associates, Estimating the debt margin, October 2011, page 8.