9 August 2013

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Email: AERInquiry@aer.gov.au

Dear Sir

Thank you for the opportunity to make a submission on the AER's Draft Shared Assets Guideline.

The EUAA represents around 100 energy users in Australia. Our members account for a significant proportion of the electricity consumed in the National Electricity Market.

In many areas we consider the AER's Draft Shared Assets Guideline is inconsistent with the National Electricity Objective. Specifically we consider that the AER has failed to determine guidelines in this area, that are consistent with the long-term interest of energy users. As a result of this, electricity users will be paying more than they should, and network service providers (NSPs) will be deriving greater profits than they should.

Our concerns in this area relate to decisions that the AER has made in the application of the Rules, and in one area to flaws in the National Electricity Rules.

In several areas we are raising issues that we have already previously raised verbally and in writing in our previous submissions. We strongly urge the AER to take note of our concerns because to date it appears that the AER is showing little evidence of genuinely considering the points made by user groups.

Yours faithfully

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Chief Executive Officer

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ATTACHMENT A

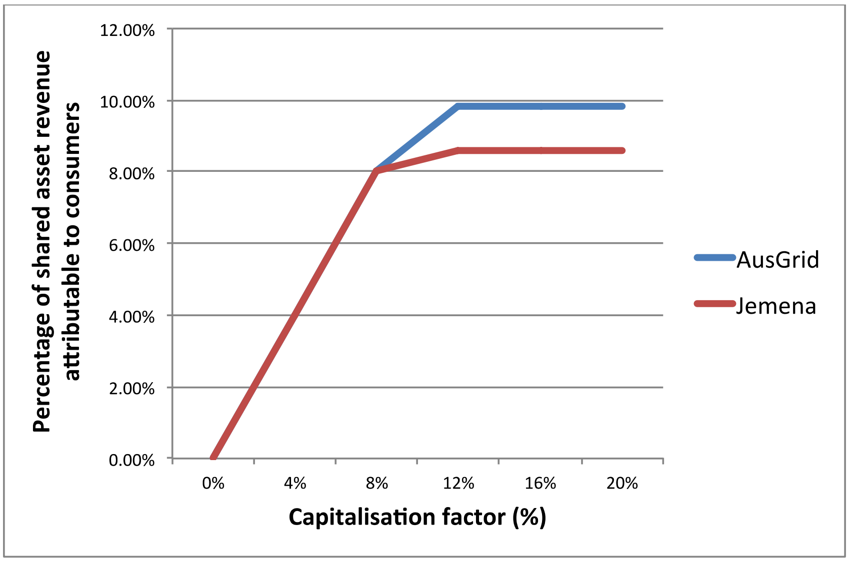
This attachment sets out the EUAA's concerns in relation to the AER's Draft Shared Assets Guideline. It starts with our analysis of how shared asset income will be shared between NSPs and users, based on the AER's guidelines. It then sets out our concerns.

Outcome from the AER's proposals

To analyse the impact of the AER's proposal we have used actual data on the depreciation, return and regulated revenues for 2013 for AusGrid and Jemena, the biggest and smallest NSPs in the NEM respectively. The AER's proposed approach is that the shared asset income that accrues to users is based on an NSP's regulated return plus depreciation multiplied by one-tenth of the ratio of shared asset income to total regulated revenue plus shared asset income. This amount is capped, under the Rules, at the value of the depreciation plus return on the shared assets.

The proportion of the shared asset income that the AER's proposed approach delivers is highly sensitive to the capitalisation rate (the ratio of the depreciation plus return on shared assets to the shared asset revenue derived from the assets) of the shared assets. The relationship is shown in Figure 1 for the largest (AusGrid) and smallest (Jemena) NSPs in the NEM

Figure 1. Distribution of shared asset income between users and NSPs



The figure shows that for shared assets that have no regulatory cost (i.e. capitalisation is zero), all of the shared asset income goes to the NSP. However if the capitalisation factor exceeds around 9%, the share of the shared asset revenue that accrues to users is based on an NSP's regulated return plus depreciation from prescribes services multiplied by one-tenth of the ratio of shared asset income to total regulated revenue plus shared asset income.

It is mathematically possible that this share can be close to zero for high values of shared asset income. However, for practically realistic values of shared asset income (say between 1% and 20% of prescribed asset income) the share of the shared asset income that will accrue to users from small NSPs such as Jemena will not exceed 8.57%, and for large NSPs such as AusGrid will not exceed 9.82%. This is illustrated in Figure 1 where we have assumed shared asset income of $25m, and used actual data on AusGrid and Jemena's 2013 depreciation, return and regulated revenues from prescribed services.

We expect that the typical shared asset will have capitalization factors of around 10%, so the typical sharing of shared asset income is likely to be circa 9% to users and 91% to the NSPs.

It should be noted that this sharing factor relates to shared asset *revenues*, not the net income (revenues less costs) from shared assets. Our presumption is that the incremental costs that an NSP is likely to incur in delivering shared asset revenues will be small. This reflects the fact that it is the shared asset that creates the value, not some additional asset for which the NSP is likely to incur significant additional costs (if this was not the case, the asset so created would not be a shared asset, but an unregulated asset).

On the basis of this presumption, our conclusion is therefore that the AER's proposed approach delivers a distribution of the benefits of shared income between NSP and users that is quite obviously in favour of NSPs, and at users' expense. We conclude therefore that the AER's approach fails to achieve the National Electricity Objective.

Issue 1: Use of shared asset revenues instead of shared asset profits

Our central conclusion, stated above, rests on the presumption that in deriving the shared asset income, the NSP incurs insignificant additional expenditure. It may be possible, that in some cases, the NSP may incur significant additional expenditure in order to recover shared asset income, and that these costs are not remunerated in some other way. For example a contract between NBN Co. and an NSP to carry fibre optic cable on NSP's poles may deliver income of, say $20m, but the NSP could incur costs (not compensated in other ways) of say $15m in order to achieve that income.

In this case, the distribution of 9% of the shared asset revenue to users, may actually turn out to be a significantly greater proportion of the profits (revenues less costs) associated with the shared asset. In this case, the EUAA's main concern with the AER's approach (that it is disproportionately in favour of NSPs) evaporates. This leads to the observation that the AER's focus on shared asset *revenues* rather than shared asset *profits* inhibits a proper assessment of the correct distribution of the benefits of shared asset income.

We have raised this issue with the AER in our previous submission and also in subsequent email and telephone contact between the AER's officers and our advisor. The AER's officers' response has been that the National Electricity Rules (Clause 6.4.4 (c) (2)) precludes the AER from regulating NSP's expenditure on shared assets. AER officers have also suggested that the Rules stop the AER from having regard to the commercial outcomes of shared assets. Despite this issues having been raised several times by the EUAA and other energy user advocates, the AER has however been silent on this in its Explanatory Statement. Therefore it is not clear what the AER's official position on this is.

For the avoidance of doubt we disagree with the AER's officers' view that it is unable to request NSPs to provide the AER data on the costs associated with the provision of services from shared assets. We reject the AER's officer's contention that a request to provide such cost data is tantamount to a regulation of such costs. Indeed, what is the difference between requesting data on shared asset revenues and requesting data on the costs that NSPs may incur in delivering that shared asset revenue?

We also disagree with the AER officers' view that the Rules hinder the AER from determining a shared based on the profits, rather than the revenue. In particular, Clause 6.4.4 (c) (2) of the Rules says that "*a shared asset cost reduction should not be dependent on the Distribution Network Service Provider deriving a positive commercial outcome from the use of the asset other than for standard control services".* The AER's officers have suggested to our advisor that this means that the AER is unable to have regard to the profits and must instead focus only on revenues. We do not agree with this. The restriction in the Rules relates specifically to a "*positive*" commercial outcome in particular, rather than commercial outcomes in general.

We understand that the AER has sought legal advice on this. If so, we request that the AER makes that advice public. If the AER's officers' interpretation of the restrictions set in the Rules are correct (i.e. that the AER is precluded from determining a share of profits and has to determine the share of revenues), then we request that the AER propose a rule change to rectify this since the sharing of revenues rather than profits is, we suggest, contrary to the National Electricity Objective. The EUAA stands ready to support the AER in this rule change if needed.

Finally, in our previous submission we suggested an appropriate calculation for sharing the profits from shared asset income. Rather than repeat that here, we refer the AER to that submission.

Concern Number 2: Setting the shared asset income control at the start of the regulatory control period

The AER has said that it will determine the division of shared asset income at the start of the regulatory control period. There is no requirement in the Rules for the AER to do this.

It will be highly problematic forecasting, effectively seven years ahead, what shared asset revenue an NSP may recover. For example, how could an NSP possibly know with any certainty now, how much NBN Co. related income it may recover over the next seven years?

In addition, there is no true-up between forecast and actual shared asset income. The combination of no true-up and long forecasting periods will encourage NSPs to under-forecast possible future shared asset income, at users expense. In other words, forecasting error will lie asymmetrically at users' expense.

This is easily rectifiable by ensuring that the AER will determine shared asset controls during the regulatory period, if required.

Concern Number 3: Materiality as a percentage of regulated revenues

The AER has set a materiality threshold of 1% of NSP revenues – in other words, the income from shared assets has to exceed 1% of the annual regulated revenue before users will have the prospect of any share shared asset income.

We do not agree that this is the correct specification for a materiality threshold. Specifically, the income of NSPs varies considerably – the largest AusGrid collects 10 times more revenue than Jemena. The 1% criterion applied to AusGrid results in a materiality threshold of $20m, while for Jemena this would be $2m. Such a significant disparity in threshold is, we suggest, impossible to justify.

Instead of a materiality threshold related to shared asset revenue as a percentage of regulated revenues, we suggest that the materiality threshold should be an absolute amount, say $2m per year.

Concern Number 4: NSPs to estimate prescribed revenues from shared assets

The AER has left it to the NSP to determine the prescribed revenue (specifically the return on assets and the depreciation) of assets that deliver shared income. This information is important and NSPs have an incentive to under-state it, since this revenue sets the cap on the amount of shared asset income that will be shared with users. For this reason, we suggest that the AER should required to determine this in the cases where the cap determines users' share.

Concern Number 5: Capping the users' share of shared asset income at the regulatory income of the shared assets

Clause 6.4.4 (a) of the National Electricity Rules says that " *the AER may … reduce the annual revenue requirement … by such amount as it considers reasonable to reflect <u>such part of the costs of that asset as the Distribution Network Service Provider is recovering through charging for the provision of (prescribed services or shared asset services)</u>*".

By implication if the asset has no cost – for example it is fully depreciated – then there is no cost recovered through prescribed services, and so no reduction in charges to users from shared asset income is possible.

If the asset had a low cost (say almost fully depreciated) then this small cost would be the cap on the reduction of users charge. This approach implies that all of the benefit of assets that users have fully funded through regulated charges, and for which users have borne all construction, operation, stranding and decommissioning risk, should accrue to the NSP, and none to users. This is obviously inequitable. It matters in the cases where the assets that deliver shared assets have a very low value (or in the language of our analysis, a low "capitalization factor").

We recognize that this is a limitation of the National Electricity Rules, not a fault of the AER's. We suggest that this Rule must be changed and we look to the AER to take the lead, which the EUAA will fully support, in proposing a change in this Rule.