Energy Users Coalition of Victoria

Australian Energy Regulator

Victorian Gas Transmission Revenue Reset

Application

from

APA Gasnet

A response

by

Energy Users Coalition of Victoria

June 2012

Assistance in preparing this submission by the Energy Users Coalition of Victoria (EUCV) was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

This project was part funded by the Consumer Advocacy Panel (www.advocacypanel.com.au) as part of its grants process for consumer advocacy and research projects for the benefit of consumers of electricity and natural gas.

The views expressed in this document do not necessarily reflect the views of the Consumer Advocacy Panel or the Australian Energy Market Commission.

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

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Executive Summary

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

The revenue reset continues the applicant's strategy of testing the regulator by seeking large expenditure allowances notwithstanding significant underspending in the previous period. An assessment of this practice demonstrates the relative success of this kind of strategy, as profitability has been significantly increased.

In the AA4 period, Gasnet is seeking capital expenditure allowances of $346 million, even though it underspent allowed capex by 27% in the previous period (AA3). This claim for an increased capex allowance is made notwithstanding a very modest increase in gas volumes projected to be transported in the AA4 period.

Augmentation capex was more than 20% less than the allowed capex in AA3 but of great concern is the question of the prudency and efficiency of two key augmentation projects. This concern also applies for the AA4 period with respect to a number of proposed projects. The AER is urged to test these proposals on prudency and efficiency criteria.

As for capex for refurbishment and upgrading, underspending in AA3 was very significant (about 50% below the allowance) with Gasnet abandoning its approved refurbishment program and undertaking other projects instead. This action raises again the question of whether the alternative projects were prudent and efficient but more disconcerting is the question of Gasnet's ability in accurate forecasting and management of projects (bearing in mind that only half of the $106 million approved allowances were spent).

Non-system capex, however, was substantially overspent, much of this being attributed to IT costs. However, it is questionable whether these costs should be allocated to customers rather than to the APA Group.

In the case of operational expenditure, Gasnet is seeking opex allowances of some 40% more than the actual opex incurred during AA3. Again, examination of the trends in opex over the previous periods (AA2 and AA3) shows a consistent trend in underspending, which demonstrates the generosity of the allowances provided by the regulator. In AA4, Gasnet is seeking opex allowances of some 40% more than the actual opex incurred in AA3. Noting that AA3 actual opex was inflated by significant corporate transfers, a comparison of AA4 opex with AA2 opex, shows Gasnet is seeking opex that is some 60% higher than average actual opex in AA2. This is in marked contrast to the modest expansion of the Gasnet system since AA2. The AER is urged to

examine the AA4 claims against these trends and to focus on corporate restructuring costs that have been allocated to Gasnet and the associated savings that should be derived from the expected synergies.

Forecasts of gas usage in AA4 are a concern. Gasnet (and AEMO) is forecasting gas transportation in 2013 will fall below 2011 actual gas flows by some 5PJ but no explanation is provided. There is considerable doubt as to whether the forecasts for gas usage are too conservative and as a result lead to an overstatement of gas tariffs for the AA4 period.

The EUCV has examined Gasnet's WACC claims and we provide below in tabular form our own views as to the correct WACC values that should be determined by the AER as they reflect both reality and the latest regulatory views of an appropriate values for setting the weighted average cost of capital for a regulated energy transport monopoly.

Parameter	Gasnet	EUCV
Risk free rate	10 year CGS	5 year CGS
Gearing	60% debt	70% debt
MRP	850 bp above 10 year CGS	600 bp above 5 year CGS
Equity beta	0.8	0.65
DRP	392 bp above 10 year CGS	195 bp above 5 year CGS
Gamma	0.25	0.25

Overall, the EUCV is concerned that the marked increase in revenues sought by Gasnet will translate into comparable increases in tariffs notwithstanding the modest increase in gas transportation projected. Importantly, the AER must recognise the trends in over recovery in capex and opex allowances that Gasnet has been allowed to benefit from over the past three access arrangement periods, The over recovery of revenues have been at the expense of consumers.

1. Introduction

1.1 The EUCV

The Energy Users Coalition of Victoria (EUCV) is a forum representing large energy consumers in Victoria. The EUCV is an affiliate of the Major Energy Users Inc (MEU), which comprises over 20 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland.

The EUCV welcomes the opportunity to provide comments on the AER's review of the revenue reset for the Victorian gas transmission business.

Analysis of the gas usage by the members of EUCV shows that in aggregate they consume a significant amount of the gas used in Victoria. As such, they are highly dependent on the transmission and distribution networks to deliver efficiently the gas so essential to their operations. Many of the members are heavily dependent on local suppliers of hardware and services. As a consequence, members consider they have an obligation to represent the views of these local suppliers. With this in mind, the members require their views to not only represent the views of large energy users but also those of smaller gas using facilities, and even at the residences used by their workforces.

The companies represented by the EUCV (and their suppliers) have identified that they have an interest in the **cost** of the energy networks services as this comprises a large cost element in their electricity and gas bills.

The widespread use of gas throughout Victoria renders it to be almost an essential source of energy required by each member company in order to maintain operations, a failure in the supply of effectively will cause every business affected to cease production, and members' experiences are no different. Thus the **reliable supply** is an essential element of each member's business operations.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of energy supplies has become increasingly important with the focus on the performance of the distribution businesses because they control the quality of electricity and gas delivered. Variations in the supply of gas, by even small amounts, now have the ability to shut down critical elements of many production processes. Thus member companies have become increasingly more dependent on the quality of energy services supplied.

Each of the businesses represented by EUCV has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is

required. If sustainable supplies of energy at a reasonable cost are not available into the future these investments will have little value.

Accordingly, EUCV (and its affiliate MEU) are keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies.

The members of EUCV have identified that gas transmission plays a pivotal role in the gas market. Consumers recognise that the cost of providing the transmission system is not an insignificant element of the total cost of delivered gas.

1.2 The scope of this review

EUCV recognizes that the AER is required to carry out its review in accordance with the new Gas Law and Gas Rules. These new Rules need to be seen as being pro investment for gas businesses, as this was a feature of the development of the Rules. Equally, consumers have assessed the new Rules (for both transmission and distribution) to be biased and unbalanced, as they clearly favour the gas transport businesses and their use to date has seen very large increases in costs to consumers.

In principle, the Rule changes result in considerable scope for the exercise of independent regulatory judgment by the AER but despite this, consumers have seen the AER take a quite prescriptive approach to regulation in other recent gas transport decisions – this especially relates to the way the AER has set debt risk premium where it persists in using a flawed mechanistic process and in its lack of benchmarking the opex and capex needs.

1.3 A review of the ACCC reset activities in 2002 and 2007

The first two revenue reset reviews of the Victorian gas transmission system was undertaken by the ACCC under the requirements of the Gas Code as the new Gas Rules were not introduced until well into 2008, by which time the ACCC had issued its Final Decision on the Gasnet application.

In the ACCC decision for AA2 (made in 2002), consumers saw an average tariff reduction over time, with Gasnet attaining considerable benefit in the latter years of AA2. The ACCC decision for the AA3 period resulted in a significant increase in allowed revenue driven by increased capex, a significant increase in debt risk premium and a reduction in forecast gas usage.

Gasnet does not provide actual revenue achieved for AA3 in its application for AA4 but a review of the annual reports for APA shows that the revenue earned by APA in Victoria during AA3 greatly exceeded the revenue allowed

by the ACCC in its final decision, indicating that the assumptions made by the ACCC in reaching its final decision in 2007[1], were substantially wrong.

$m (nom) pa	2008	2009	2010	2011
ACCC allowed	103.0	110.6	118.3	121.7
APA annual reports (Vic segment)	102.0	126.4	136.8	151.2
Gasnet compliance report 2008-09	119.0	139.0		
Extra revenue over allowed	-1%	14%	16%	24%
Extra gas transported over forecast	2%	2%	4%	8%

Source: ACCC FD 2008, Gasnet ARs, Gasnet applic, VENCorp APR 2007

This indicates that the AER needs to examine closely the claims made by APA in its application to ensure there is not a recurrence of Gasnet earning significantly more than the AER considers is efficient. A review of the forecast volumes of gas used compared to the actual volumes carried, shows that, on average over the four years 2008-2011, there was 4% more gas transported than was forecast, with nearly 8% more in 2011. Whilst underpinning some of the increase in revenue, this increase in gas flows does not provide the reasons why the revenue rose as high as it did.

In its application, Gasnet provides details as to the actual expenditure on capex and opex compared to the allowance provided by the ACCC for AA3. In terms of expenditure, for the first four years of AA3, Gasnet used only 51% of the capex allowance and 82% of the opex allowance yet the revenue allowed included for the higher amounts. Adding to these expenditure under-runs, the actual debt risk premium for the first four years averaged about 70 basis points below the allowance provided by the ACCC.

When the Gasnet over-recovery of revenue compared to the allowance is added to these expenditure savings, consumers have paid a very high price to Gasnet for the provision of gas transmission services during AA3.

1.4 An overview of the Gasnet application

It is quite clear that the pipeline companies have taken to heart that the new Rules are to encourage investments. Across the board capex demands are significantly inflated from the current period, as is opex demand. Against this backdrop, it is noted that AEMO is forecasting a very modest increase in gas consumption in Victoria, with only slightly increasing forecasts in daily gas usage.

[1] There is a difference between the revenues earned by Gasnet between the compliance report for APA Gasnet for 2008-2009 submitted to the AER and the revenue stated as earned in Victoria in the APA annual reports segmented performance for the same years. The compliance reports indicate that more revenue was earned by Gasnet than was recorded in the annual reports for Victoria. However, both sets of figures show that actual revenues were higher than the revenues allowed by ACCC.

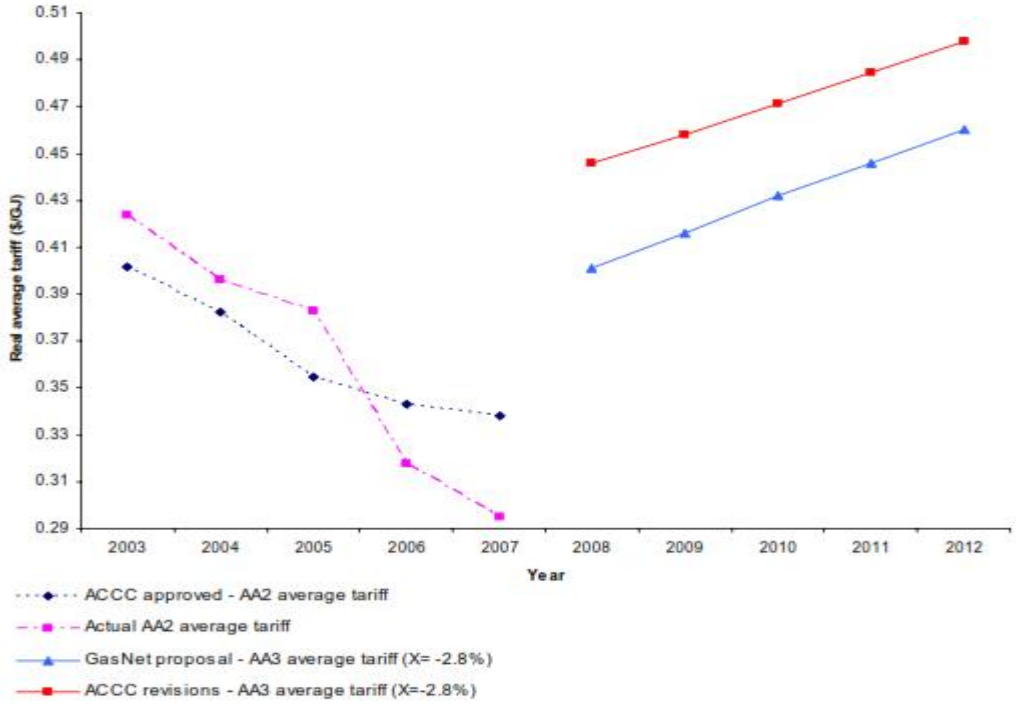
For this increase in expenditure, consumers will have to pay considerably more, but ironically, will pay more for the same service and delivery quantities. The regulatory bargain is now so unbalanced that it has undergone a major shift in favour of the network businesses. What is totally missing from the applications is an assessment of value for money.

Gasnet has requested a real step increase in revenue at the start of the next period followed by real increases for each of the following years. What is not addressed (other than a peculiar view that the increased cost of transmission is a minor element when seen in context of the overall cost of delivered gas) is the impact this will have on gas consumers – specifically whether prices are at efficient levels or even their ability to pay for such large annual increases.

The EUCV considers there is essentially an inconsistent proposition being propounded by Gasnet. Already we have seen the ACCC provided for increases in annual revenues but which Gasnet was able to significantly exceed by on average more than 20% in the first four years of AA3. This means that tariffs were set by the ACCC some 20% on average higher than needed.

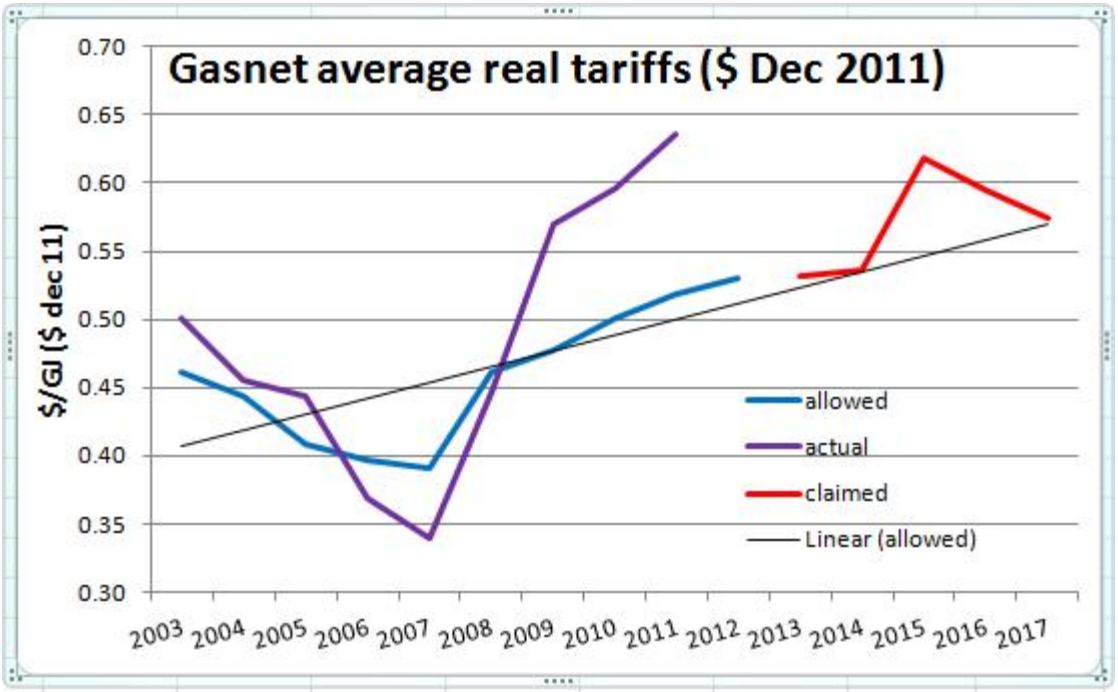
The following chart was included in the ACCC final decision for AA3. Clearly a 20% reduction in allowed tariffs to reflect this over-recovery would have resulted in a very modest step increase in tariffs between the last year of AA2 and the first year of AA3 and a lower rate of increase in tariffs over AA3.

Figure A.1: Tariff path



The application from Gasnet seeks to further increase tariffs based on higher rates of return, higher capex and higher opex. During period AA3, Gasnet was granted a real increase of 2.8% in tariffs in addition to the step increase allowed at the start of AA3.

The following chart provides the movement in average tariffs (revenue divided by total gas transported) over time, for the allowed average tariffs in AA3, the actual average tariffs in AA3 and the forecast average tariffs for AA4



Source: Gasnet ARs, ACCC decision 2008, Gasnet proposal

The chart demonstrates that the forecast tariffs would follow the trend of the allowed tariffs by increasing, as sought by Gasnet, in real terms by 3% pa. But as noted above the allowed revenues (and the resultant tariffs) have permitted a significant over-recovery implying that the average tariffs allowed in 2008 were significantly overstated.

However, with the actual under-spends in opex and capex achieved by Gasnet, the allowed tariffs for AA3 were even more overstated as the ACCC have included for unnecessary costs that were not realized.

When these two factors are included, there is no doubt that the Gasnet forecasts are greatly overstated and lead to significantly overstated average tariffs for AA4.

1.5 The EUCV'S General View

The EUCV is supportive of the requirement for reliable security of gas transmission and is not opposed to network augmentations and additions, provided the investments are **efficient** and they are implemented by a **prudent** network business.

Against that background, it is instructive to refer to the Minister's Second Reading Speech (on the National Gas Law)[2]:

[2] Hansard, SA House of Assembly - Wednesday, 9 April 2008, Page 2884

> "The alignment between the objectives of the gas and electricity regime is an important foundation for the regime. A single consistent objective across gas and electricity will increase the prospect that the regimes remain closely aligned over the long term, even in light of the capacity in both regimes for interested parties to make applications to change rules through the Australian Energy Market Commission.
>
> The national gas objective is to promote efficient investment in, and efficient use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, reliability and security of supply of natural gas.
>
> The national gas objective is an economic concept and should be interpreted as such.
>
> The long term interest of consumers of gas requires the economic welfare of consumers, over the long term, to be maximised. If gas markets and access to pipeline services are efficient in an economic sense, the long term economic interests of consumers in respect of price, quality, reliability, safety and security of natural gas services will be maximised. By the promotion of an economic efficiency objective in access to pipeline services, competition will be promoted in upstream and downstream markets."

It is pertinent to recognize that the gas and electricity objectives are the same and are aligned to ensure the same outcomes. This is because the Minister's second reading speech for the National Electricity Law provided a more detailed explanation as the meaning of "efficient"

In the second reading speech for the National Electricity Law (where the objective was described in more detail) the Minister stated[3]:

> "For example, **investment in and use of electricity services will be efficient when services are supplied in the long run at least cost**, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities."(emphasis added)

To permit expenditure (or allow recovery of actual costs or of costs never incurred such as indexation adjustments) that is inefficient or unnecessary, or for costs previously charged to consumers as expenses of a business, could not be described as supplying services at least cost or maximizing the welfare of consumers.

The EUCV would expect the AER to have regard to the request of Gasnet (with its ex ante allowances for capex) to more than double its capex

[3] Hansard, SA HOUSE OF ASSEMBLY, Wednesday 9 February 2005, page 1452

allowance from AA3 to AA4 against the background of a gas usage that increases at less than 1% pa.

The overwhelming challenge for both Gasnet and the AER is to ensure that the investments (in capex) it proposes are **efficient** (i.e. that there is a need "in the long run at least cost" to the consumer), that they are being undertaken by a **prudent** network business and that consumers accept the need for the investment for the cost involved.

Businesses in a competitive environment make judgments on investment based on such requirements as the

- Potential to recover the planned return on the costs needed for the investment,
- Ability to deliver a project on time and to budget,
- Cost (including short term supply pressures),
- Ability of customers to absorb cost increases[4],
- Ability to defer the investment and the risks associated with deferral.

In the case of a regulated business, prima facie, it only has to convince the regulator it needs to expend the funds and effectively does not take responsibility for whether the investment will generate the required revenue, or even whether it over-runs on costs, as the Rules effectively allow actual costs to be rolled into the RAB, with little deep assessment as to whether the costs were truly prudent let alone efficient.

Unfortunately, gaining regulatory approvals for capital expenditure has been observed to be far too easily obtained, with greater emphasis given to the stated wants of the business rather than the imposition of strong development of capital controls (such as occur in businesses subject to competition) in the interests of consumers.

In this regard, it is to be noted that one of the many reasons given by regulated businesses for needing to invest more capital now, is that under previous government ownership and control, the businesses were starved of capital, due to the competing needs within the government budgets. Another construct that could be applied though, is that governments (just as do businesses in the competitive environment) applied very strict requirements on capital expenditure.

As can be seen from the regulatory decisions made since governments handed over the responsibility of providing the necessary discipline on monopolies to jurisdictional and national regulators, the obtaining of approval to incur capital expenditure (based on a requirement that

[4] This aspect of assessing the ability of its customers to absorb to costs associated is an element that is totally lacking in any assessment by the AER in previous regulatory decisions yet is fundamental to decisions made in a competitive environment

consumers have to pay regardless) has seen an explosion of new capital works undertaken, combined with very large increases in opex. This clearly demonstrates that regulators are failing consumers and not acting in concert with the NGL objective by not applying the same level of discipline on regulated gas network providers as was applied by governments themselves, when acting as owners of the assets.

1.6 Summary

It is essential that regulatory price reviews do not lose sight of the basic fact that if the regulator keeps on allowing increases in capex and opex, the prices the networks will charge for providing what is effectively an essential service will help take the cost of gas beyond the ability of competitive industry and many consumers (especially disadvantaged consumers) to pay.

We are already seeing price pressures on the supply of gas as a commodity as a result of the movements in domestic gas prices towards export parity. To this is added the cost of the price on carbon which imposes both direct and indirect[5] cost increases.

The national and jurisdictional regulators have permitted large increases in their recent revenue reviews and if a similar approach is taken in relation to the Victorian gas reviews, gas will become unavailable to many consumers and cause manufacturing to migrate off shore, resulting in the de-industrialization of the Australian economy.

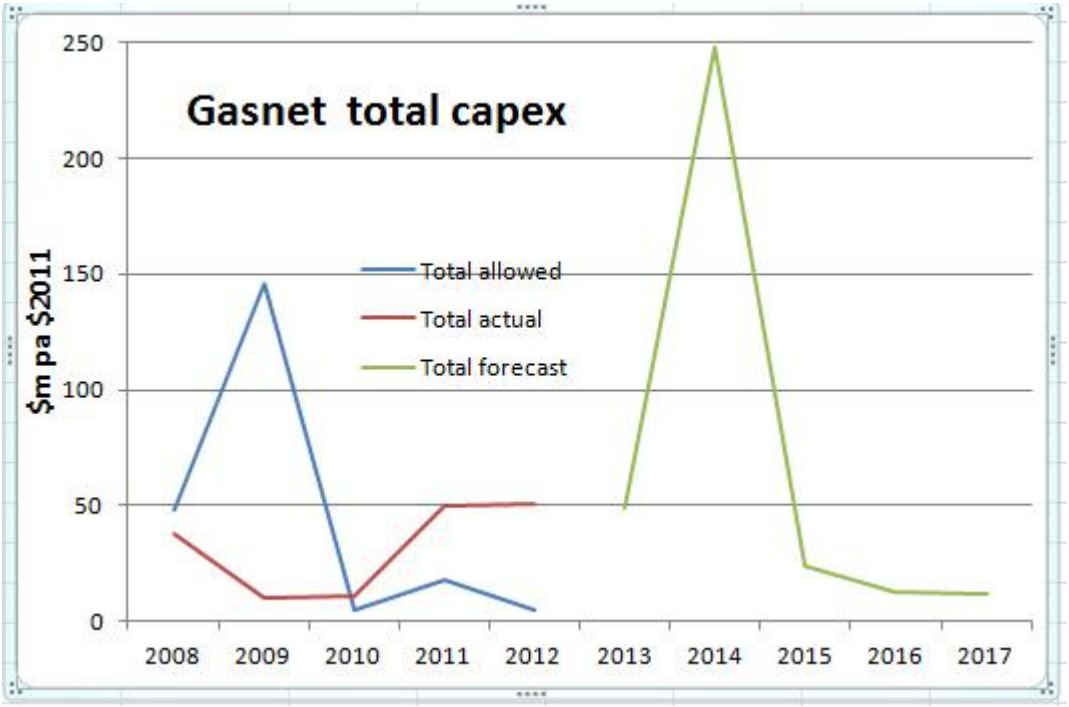
Regulators need to recognise that as more and more large gas users either move off shore or close down, this will result in those fewer consumers remaining having to carry an even greater share of the gas supply chain prices, driving unit prices up even higher.

[5] Indirect cost increases in gas result from the move away from coal fired power generation to gas, increasing the demand for gas with resultant price pressures

2. Total Ex-Ante Capital Allowance

2.1 An overview of the Gasnet capex claim

The forecast total capex for AA4 can be seen in comparison to the much lower actual capex for AA3 in the following chart.



Source: ACCC FD 2008, Gasnet application

For the current period (AA3) the ACCC allowed Gasnet to incur $222m of capex within the allowed revenue. In fact, Gasnet only used $160m of capex for the period. Gasnet advised that in AA3, it used most of the allowance for augmentation works, it considerably underspent on refurbishment and upgrades and overspent on non-system capex.

Overall, Gasnet underspent the allowed capex by 27% but is permitted to retain the benefit of this underspend. Gasnet also deferred the actual expenditure of the capex considerably from the timing of the capex allowances, again creating an additional benefit for Gasnet. The net value of this deferred program and reduced capex incurred increased Gasnet's profitability by $49m or an average of $10m each year.

Despite significant underspending in AA3, Gasnet has sought an increase in capex for AA4 to $346m, an increase of more than double what was spent in AA3. In global terms, this is a questionable and massive increase and will impose considerable cost pressures on gas consumers for many years to come.

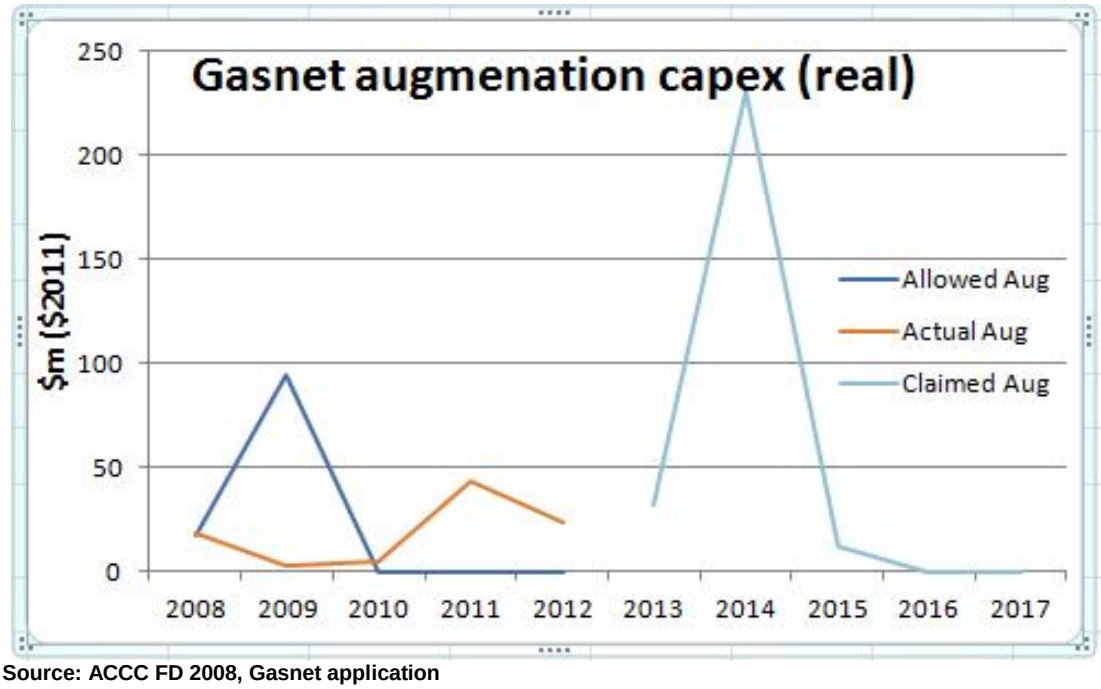
This massive increase in capex by Gasnet must be seen in light of the projected very modest increase in gas volumes being transported through AA4. During AA3, there was a similar low annual increase in gas volumes being transported.

Prima facie, there is little reason for the AER to grant any more capex for AA4 than was actually used in AA3, because the drivers for capex remain essentially unchanged between the two periods.

2.2 The breakdown of the capex claim

Gasnet advises that its capex is allocated to three main aspects – augmentation, refurbishment and upgrade and non-system capex. Allowed and actual capex for AA3 and forecast capex for AA4 for each element are shown in the following charts.

2.2.1 Augmentation capex



Source: ACCC FD 2008, Gasnet application

Augmentation capex for AA3 was actually more than 20% less than the allowed capex. Gasnet attributes much of this under-run to careful and better planning and good project management in seeking alternatives.

Equally, the decision of the ACCC to allow so much capex for increasing the capacity of the Northern system (to allow increased sales to NSW) would appear not to reflect prudent investment as the actual increase in sales to NSW have been modest and Gasnet is not forecasting significantly more gas sales to warrant such a large capex program. Prior to the

northern augmentation, gas sales to NSW were some 10 PJ pa and Gasnet is forecasting perhaps an additional 10 PJ pa of sales now the northern augmentation is complete, although Gasnet advises that the augmentation will provide an additional capacity of an additional 14 PJ pa. Thus for $4m p.a. in increased sales in AA4[6], Gasnet incurred a capital cost of some $67m (see application page 77) costing consumers some $7m pa plus depreciation. Such an investment is not one that is prudent let alone efficient. The AER needs to investigate this investment much more closely and, if necessary, exclude some of the capex from being rolled into the regulatory asset base.

Because of the apparent imprudent northern augmentation, the EUCV considers that the AER needs to examine the investment made on the Brooklyn Lara Pipeline (Corio Loop) to ensure that the cost of the investment can be demonstrated to be prudent and efficient when considering the increased revenue generated from additional gas flows to the cost to consumers and the 50% over-run on costs advised by Gasnet in table 6.2.

In AA4, Gasnet is intending to invest some $158.1m on augmenting gas flows from Iona in the south west to Culcairn in the north east and $110.4m for the Western Outer Ring Main (WORM) project (of which $13.5m will be expended in AA3) which is intended to improve security of supply should the Longford gas processing plant fail (as it did in 1998). Of the remaining augmentation capex, Gasnet specifically identifies the Anglesea project ($13.3m), Warragul lateral project ($2.6m) and Kalkallo lateral project ($4.3m).

The Iona to Culcairn project does not appear to be prudent. The cost (using the Gasnet proposed rate of return) will be some $19m plus depreciation yet the revenue from the project will be an additional 45 TJ/day (a maximum of 16.4 PJ/a providing a revenue based on the average tariff of $6.6m pa. It is accepted that the EUCV calculations are quite simplistic; the tariff for such haulage would have to be more than 3-4 times the average tariff to make this project prudent when the cost regulatory depreciation is added to the required return on investment.

Gasnet advises that its other major augmentation is the WORM project, designed to improve security of supply in the event of a loss of supply from Longford. This project will cost $110.4m and already Gasnet has committed some $13.5m during AA3. Gasnet refers to appendix c-5 which explains why this residual risk is material but fails to provide this for scrutiny. The EUCV does accept that there is a risk to security should Longford fail to supply, but this risk is no different to that faced by any gas using centre

[6] Even if the full increased capacity of 14 PJ pa was achieved, this would still only return $5.5m pa so this augmentation does not appear to be prudent. If the full cost of $93m had been incurred the cost to consumers would have cost $10m plus depreciation, making the project even more imprudent

essentially supplied from two locations as both Adelaide and Sydney are – Brisbane has only one source of gas. Even if Longford does fail, Otway will be insufficient to supply Melbourne as considerable gas flows from Otway to Adelaide. Victorian gas consumers have already been levied with the costs to provide the SW pipeline and the Culcairn interconnect as a direct result of the decision to improve supply security after the loss of Longford in 1998. In the absence of better explanation, the EUCV finds it difficult to accept the need for the WORM project, especially considering the increased cost it will add to gas transport costs.

The Gasnet application cites that the WORM project will result in (page 101):

- "Delivers required security of supply at a lower cost than alternatives that deliver similar security of supply;
- Avoids significant stay in business capital expenditure, effectively reducing the cost of the security of supply option to one that is net of that avoided work;
- Simplifies operation of the VTS, lowering operating costs and reducing the risk of operator error;
- Supports gas competition by providing greater scope for gas injected from the west to compete with Longford gas;
- Is consistent with the long term investment strategy for the VTS, laying the foundation for growth as envisioned by VENCorp in its 2030 Vision document and
- Delivers the lowest long run costs of project alternatives assessed, while also providing a basis for meeting the longer term development needs of the system."

Whilst these are all laudable, they do not demonstrate that the project is prudent or efficient as Gasnet provides no quantification of the benefits and the EUCV notes that the cost of operating the Gasnet network does not decrease.

The AER should require Gasnet to provide greater detail of this project, its rationale and value for money so that consumers can see firsthand why this expenditure is necessary. Prima facie, the significant growth of the Gasnet network over the past 15 years compared to the modest increase in gas volumes transported does not warrant this additional "security of supply" project.

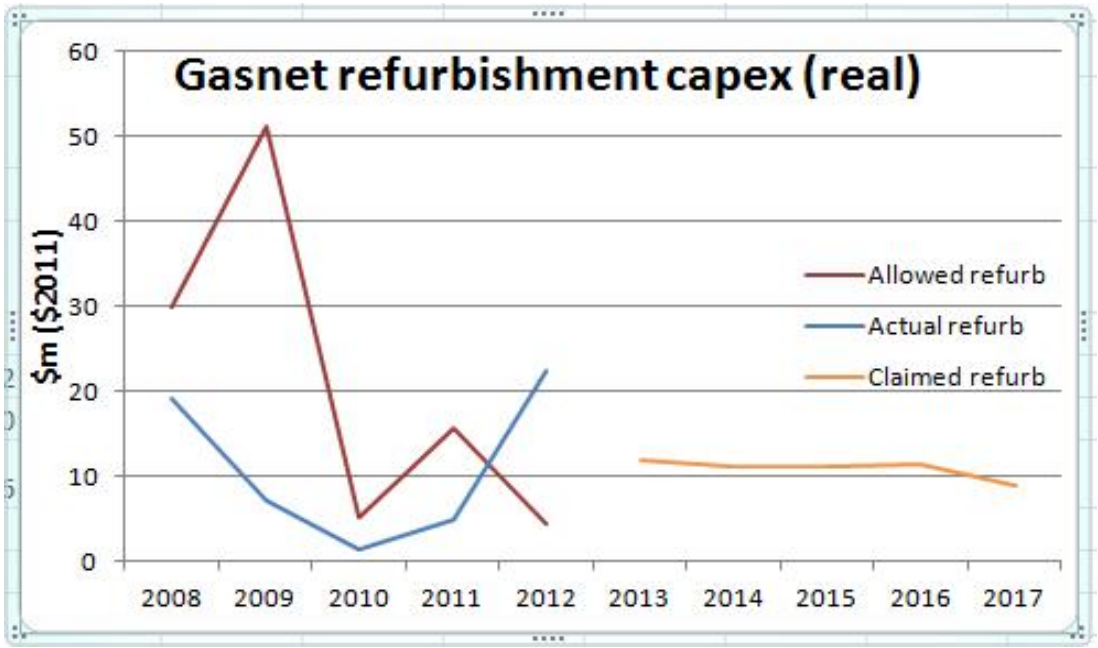
Due to the lack of detail on the other three smaller projects, the EUCV is unable to comment on the value for money that they might provide. In the absence of supporting data, the AER should reject the projects from inclusion in AA4.

The EUCV is very concerned that Gasnet has already implemented a number of large augmentation projects, and proposes more, where the value for money does not appear to warrant the additional cost that Victorian gas consumers have to bear.

There is also a concern that some of the projects being proposed are influenced by a view that there *might be* an increase in gas consumption due to increased gas fired generation resulting from the imposition of a cost on carbon emissions. The fact that the forecasts of future gas demand do not recognise any significant increase in gas demand, increases the concerns of consumers that they might be exposed to unnecessary investment because of the influence of this assumption.

The AER must be very diligent in assessing the financial prudency and efficiency of the projects proposed by Gasnet.

2.2.2 Refurbish and Upgrade capex



Source: ACCC FD 2008, Gasnet application

For AA3, Gasnet was granted refurbishment capex of some $106m yet actually used only half of this, averaging actual spending of about $10m pa. In the process, Gasnet elected not to follow the program for which the refurbishment program had been based but changed this to other projects they consider to be necessary. The EUCV recognizes that the ex ante approval of capex permits this variation but it raises two core questions.

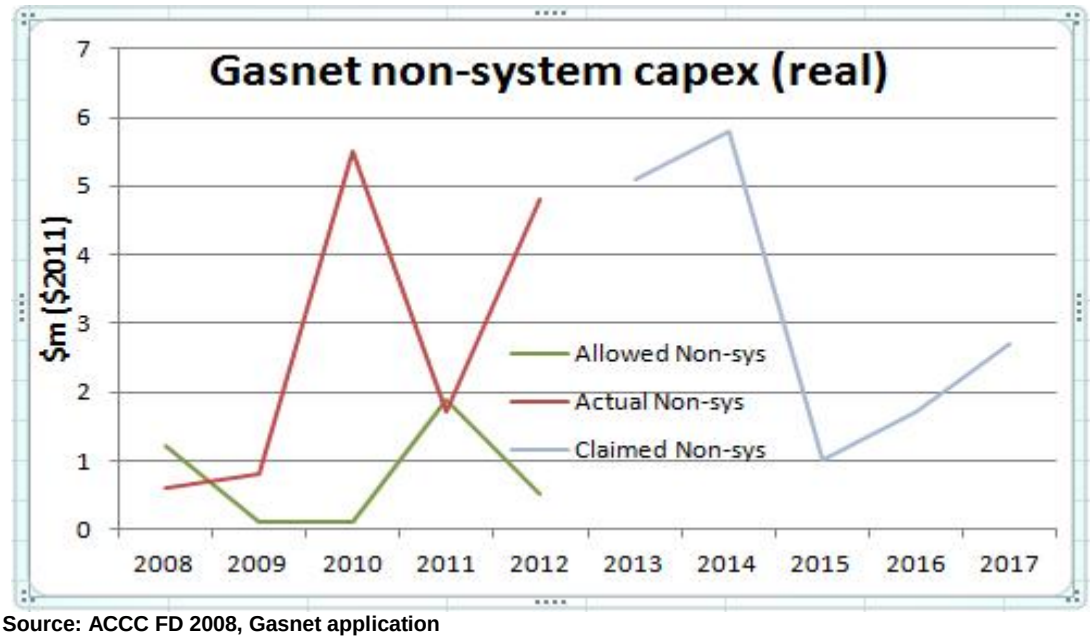
1. Were the alternative projects prudent and cost effective in the first instance? The AER must examine these to ensure whether they should be included in the regulatory asset base.

2. More concerning is that Gasnet successfully argued to have $106m for certain refurbishment projects yet changed from these and ultimately only used half of the allowance. This raises serious concerns about Gasnet's ability to forecast accurately its assets needs. The AER should bear this lack of ability in accurately forecasting needs when assessing the new capex program proposed by Gasnet.

The forecast refurbishment program for AA4 seeks about $10m pa for the next five years. This appears to be reasonable when considering the expenditure for the past five years averages this amount – that is the historic performance indicates that this amount of capex is reasonable for AA4.

The EUCV has only one caveat to this ostensible support for this amount of capex – the AER must ensure that the average $10m pa incurred during AA3 was prudent and provided value for money.

2.2.3 Non-system capex



Source: ACCC FD 2008, Gasnet application

During AA3, the ACCC agreed to an average spend of $0.8m pa for non-system capex. In fact this amount was used on average for three of the years but in the third and fifth years, Gasnet expended an additional $10m, thus causing this category to over-run by 350%. As noted above in section 2.2.2 this massive over-run reflects poorly on Gasnet's ability to accurately forecast. This raises again the question why consumers should be bearing all the risks of poor forecasting. Continuation of this practice (if permitted by the AER) will impose further risks and costs to consumers.

Gasnet explains that it incurred some $9m in unexpected IT costs because APA Group decided that significant upgrades were required and this additional $9m cost incurred by Gasnet was its share of the APA Group commitment. The EUCV does not question whether APA Group needed this upgrade but queries whether Gasnet (a regulated business which up to its acquisition by APA was a well operating standalone entity) needed these costs to be incurred. The AER is required to assess Gasnet operations as an efficient provider of the services, and not whether because of its acquisition it incurs costs because the acquirer sees a need to have an integrated IT system which can accommodate the needs of a diverse portfolio of regulated and unregulated assets.

The EUCV is of the view that these non-system costs were not necessary to continue the efficient operation of Gasnet as the service provider because Gasnet was already able to operate successfully without the need to harmonize its operations with its new owner. As the existing systems were adequate for the service provision, imposing new IT systems on Gasnet operations cannot be considered a prudent cost for Gasnet (and paid for by its customers), although it might be considered to be prudent for APA.

On this basis the EUCV does not consider that the IT upgrades undertaken by APA for its needs is a prudent expenditure for Gasnet and this cost should not be allowed in the regulated revenue.

For AA4, Gasnet advises that it needs to expend some $10m on new buildings and more (unquantified) on harmonizing the SCADA with APA groups IT systems. As noted above, the EUCV does not accept that the regulated revenue should include costs for Gasnet to harmonize with APA IT systems as this is a decision for APA as the owner of a portfolio of assets.

With regard to the supply of new buildings, the EUCV points out that the cost to consumers of these new building would be over $1m pa in return of the assets plus depreciation. The EUCV considers that there needs to be an assessment made as to whether these buildings need to be on the Gasnet site and could be leased with the lease costs being a lesser amount and included as opex. It is unusual for firms to own buildings as they are aware that lease costs are considerably less than the costs of owning a building.

The EUCV considers that the AER needs to ensure that the lowest cost option of refurbishment, replacement or leasing is included in the regulatory revenue.

When the building and IT harmonizing costs are excluded, the remaining non-system costs appear to be consistent with those in the past.

2.2.4 Timing of capex

Gasnet proposes to move away from its historical approach of incurring capex timing “as at commissioning”, to an “as incurred basis”. The EUCV sees that this would reduce the need for working capital by Gasnet and would reduce the amount of capital rolled into the asset base because there would be lower financing costs to be capitalized.

In principle, the EUCV does not object to this change providing that the benefits of receiving earlier revenue are incorporated into the regulatory financial modeling and costing of capex.

2.2.5 Escalation of costs

However, Gasnet advises that its base costs for capex relate to costs applying at 2012. It refers to a report (appendix C-1) which confirms that but unfortunately this document has not been provided so the EUCV cannot provide its comments on this aspect.

It then added forecast escalation for labour to reflect costs applying at the time of the capital works. The EUCV comments on this aspect are provided in section 4.

The EUCV has reviewed the documents available and cannot see where Gasnet seeks escalation for materials. It is possible that this information is embedded in the documentation that is not made available for public view.

However, EUCV affiliate NTMEU responded to the recent application made by another APA Group member (NT Gas) in relation to an application for a regulatory reset on the Darwin Amadeus Pipeline which is also a gas transmission pipeline. In this application, NT Gas did not seek escalation of materials so it is assumed that Gasnet sees that CPI is sufficient to accommodate any change in the costs of materials it may use.

This then raises the issue that the AER must ensure that any labour escalation is not applied to the increased cost of materials. This means that the AER would have to seek advice from Gasnet as to the proportion of the capex elements that are related to materials and ensure that the labour and materials allocation reflects this split.

The application also makes the differentiation between Gasnet employed labour (EGW) and construction labour. Again the documentation does not provide an indication as to the proportions of direct labour and construction labour that exists in the capital works. This needs to be defined appropriately.

2.3 Summary of capex cost

The EUCV has identified a number of areas of concern in relation to both capex incurred in AA3 and in capex forecast for AA4.

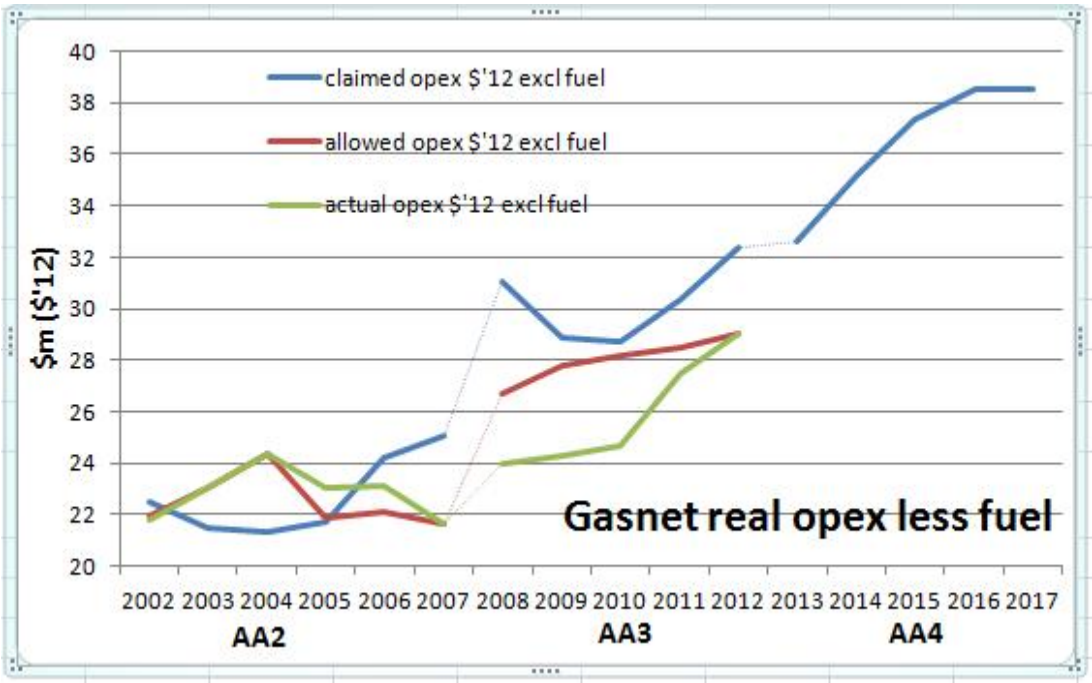
The EUCV is very concerned that the current Rules provide a strong incentive for regulated businesses to over-state their capex needs and retain the benefit of any under-run as Gasnet has in AA3. As the EUCV has quantified, this benefit for Gasnet for its under-run in AA3 has been considerable.

Further, the EUCV is very concerned that capex already incurred has not been demonstrably efficient nor prudent in that there is no evidence that the cost of the capex is offset by the necessary increase in revenue to pay for the cost of the investment

3. Forecast Operating Expenditure

The EUCV considers that, with such a large step increase in capex projects, it would be expected that Gasnet would have provided a reduction in opex as a result of improved productivity (as stated in the capex program), from greater synergies and management rationalization resulting from the acquisition by APA and savings from maintenance programs no longer required on replaced assets. However, what is being seen, is a large step increase in opex as well as the large capex claim.

The following chart shows the transition of Gasnet opex over time. Because the use of gas fuel was excised from the Gasnet opex during AA3, the opex in the chart excludes the cost of fuel gas for all periods, to ensure consistency.



Source: ACCC FD 2008, Gasnet applics

It is interesting to note that the claimed, allowed and actual opex in period AA2 all fall basically within the range of $23m +/- 5%. For AA3, Gasnet claimed a step increase in opex of an average 33%, was allowed an opex increase of 25% and spent an average of 13% more than in AA2.

Another interesting observation is that Gasnet expected that its opex at the end of AA2 would rise, but in fact the actual opex was lower in 2007 than in the previous year that was used as the “benchmark year”.

Despite APA imposing an additional $47m in corporate costs above the allowance provided by the ACCC for AA3, Gasnet still was able to make a saving in its overall opex allowance.

Gasnet is forecasting a need for opex in AA4 which averages some 40% above the actual opex incurred during AA3.

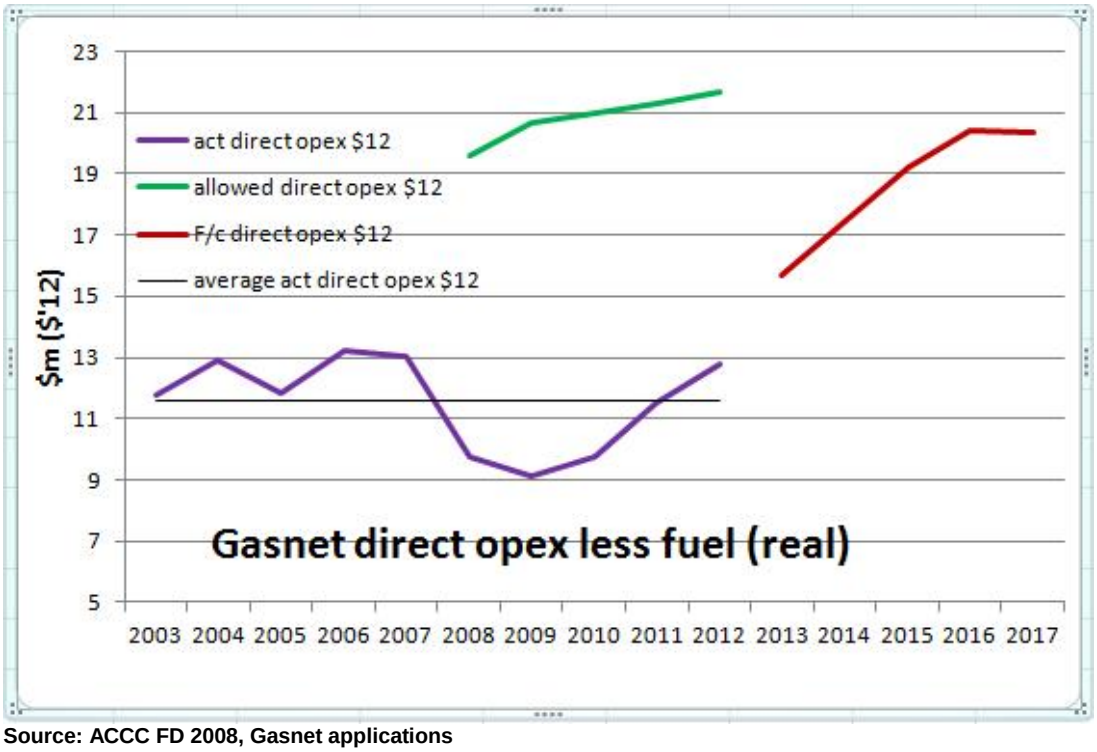
Noting that the AA3 actual opex is inflated by significant corporate transfers from APA, a comparison of AA4 opex to AA2 opex is pertinent and shows that AA4 opex is forecast to be 60% higher than average actual opex in AA2. Yet overall, the expansion of the Gasnet system has been quite modest since AA2.

Thus, on a global scale, it is quite apparent that Gasnet has significantly overstated its need for additional opex for AA4. To identify those aspects of the Gasnet opex that are overstated the EUCV has broken down the historical use of opex into two major elements – direct opex which includes labour, materials and outside services and corporate and other. As noted above, fuel gas has been excluded from all comparisons.

Even including the transfers of APA corporate costs to Gasnet of $47m during AA3, Gasnet used less opex than the ACCC allowed, including a return on the opex under-run, and a benefit equal to $14.2m from under-running opex in AA3.

3.1 Direct opex

The following chart plots the allowances, claimed and actual opex over time.



Source: ACCC FD 2008, Gasnet applications

The average direct opex (labour, materials and outside services) shows a significant consistency over the years of about $11.6m pa. Gasnet operations generated a significant fall in costs during the early part of AA3 although the direct opex for the "benchmark year" and the forecast opex for the last year show a significant upturn to previous levels.

The allowance for AA3 was an average of $20.8m pa giving a considerable saving of $46m to Gasnet over AA3. There was an under-run in all three categories comprising this aspect of the opex with all elements (labour, materials and outside services) being actually about half of the ACCC allowances. Other than providing the values of these savings (see table 9.2). Gasnet provides no explanation as to why this massive under-run occurred despite the extensive explanation regarding the drivers of the increased corporate costs, the change in approach to fuel gas costs and the restructure of Gasnet management.

There is little doubt that the efficient level of direct opex (labour, materials and outside services) for Gasnet should be no more than $12m pa based on the past performance of Gasnet over a considerable period of time. Gasnet has been the subject of an incentive to increase its efficiency and this supports the EUCV view that the efficient level should be no more than historic performance levels.

The usual reasons for increasing opex above the historical efficient level are from the scale factors of:

- Increase in consumption
- Increased customer numbers
- Increased demand
- Increase in geographical area

In the case of Gasnet, the increase in daily demand and annual consumption has been consistently less than 0.7% pa and that this rate of increase has applied across the entire AA2 and AA3 periods means that improvements in efficiency have offset the causes of the increases. The fact that in the early years of AA3, Gasnet made significant apparent improvement in efficiency which was not maintained in the later years, needs a little more investigation.

The EUCV and its affiliates have seen consistent trends in apparent opex by a number of regulated firms where early opex gains have been offset by later year increases. A reason for this has been stated to be that regulated firms under-run opex in early years and increase this in the latter years because regulators have made it clear that they consider the fourth year of a regulatory period to be the base year for setting the next year opex – just as Gasnet has done in its application. This approach provides two benefits

to the regulated firm – a high starting point for setting the next period opex and the ability to retain the full benefit of the under-run.

This is a form of regulatory gaming and the EUCV considers that the only way to prevent this is to use longer term averages of actual opex.

Another often cited cause of increased opex is if the RAB increases. This is based on the premise that increased RAB is a result of increased assets. Whilst augmentation of the network might increase the need for opex (eg increased length of pipeline) increasing the size of assets (eg a larger compressor) does not cause more opex and in fact might reduce the opex because the old (with associated high maintenance) is replaced with new assets requiring less maintenance. Refurbishment and replacement should result in less maintenance by replacing old with new.

Gasnet provides a detailed breakdown of the many changes in the business environment in which it works, including changes in requirements for environmental, safety and legislative reasons. What Gasnet fails to point out is that during AA2 and AA3 periods, similar requirements were imposed yet it was able to absorb these and still maintain the same level of direct opex. This aspect reveals two essential elements:

1. The incentive program is designed to encourage Gasnet to be more efficient and be able to absorb these costs
2. To a degree, these costs are not unique to Gasnet operations (all firms are subject to such changes) and that the risk imposed by these types of changes are built into the overall market performance and included in the market risk premium and the general inflation adjustment that is a result of these costs being accommodated across the nation.

Overall, the EUCV does not consider that there is a need to adjust the Gasnet direct opex for the step changes noted by Gasnet.

Of all the step changes sought by Gasnet, the most contentious are:

- Carbon costs. Gasnet claims that it will be exposed to between $2-3m pa for the cost of carbon. It provides no detail for this cost. The EUCV can see that Gasnet would be exposed to the cost of carbon through the use of gas for compression, but as the carbon legislation imposes this cost onto sellers of gas and because fuel gas is a pass through cost anyway, this cost of carbon does not apply to Gasnet. Gasnet does not require replacement of fugitive gas (a major issue for gas distribution businesses) as this is included in its pass through arrangements. Gasnet needs to provide a detailed explanation as to where it is exposed to carbon costs. The ACCC has publicly stated its concerns about carbon costs being unnecessarily passed on to

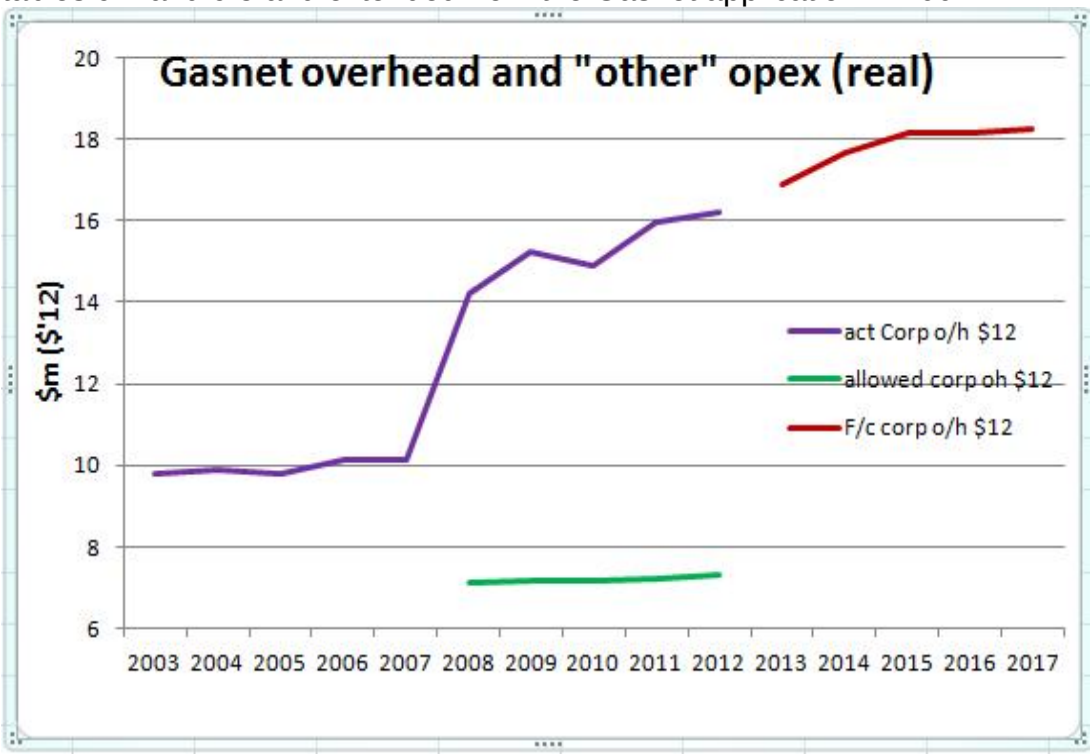
consumers and perhaps this aspect should be referred to the ACCC for further consideration and investigation.

- Apprenticeship program. The EUCV appreciates the fact there is a shortage of skilled labour, but this is not unique to Gasnet. EUCV members also have considerable need for skilled labour and they also run apprenticeship programs, but they have to absorb these costs because they are exposed to competition for their products and cannot pass through these costs. As the issue of apprentices is a national issue, and not unique to Gasnet, Gasnet should do what all other firms do, and train their own at their expense. Further, Gasnet does not identify whether this decision to take on apprentices is a step change because they have never had apprentices before. As the skills shortage has been applying for many years already, the EUCV considers that Gasnet has already had the cost of apprentices embedded in their opex over the past decade. If Gasnet has not been training apprentices, then they have been securing skilled labour from those that have (like gas consumers) and who probably could not claim the cost as Gasnet proposes to do.
- Gasnet considers that heating facilities, actuator overhauls, pressure vessel inspections and hardstanding restoration are all step changes. This implies that Gasnet has not carried out these activities in the past and therefore would not be in its long term opex. The EUCV does not accept that these are step changes as they are works that have always had to be carried out and are embedded in the long term opex.
- Reset costs. Gasnet considers that it should be entitled to recover the costs it incurs for the reset as a step change. Already in the opex there have been accommodated reimbursements of resets. Gasnet wants to claim the costs of the next reset (for AA5) within the revenue for AA4, as well as the costs for the reset for AA4. This merely loads up the opex for AA4 unnecessarily. The EUCV considers that to reimburse Gasnet for spending large amounts of money to provide it with arguments to require consumers to pay more for Gasnet services is bizarre in the extreme and places no pressure on Gasnet to be efficient with its reset costs.

3.2 Corporate, overhead and other costs

The following chart plots all of the non-direct costs such as corporate, overhead and “other” costs included in the Gasnet details of opex. There is no clear definition as to what “other” opex is intended to cover, but it would appear that they are not direct costs for operating and maintaining the Gasnet system as they have not been included in those elements listed as direct costs.

These "indirect" costs plus the direct costs discussed in 3.1 above, comprise in total all of the elements of Gasnet opex less fuel detailed in tables 9.2 and 9.5 and extended from the Gasnet application in 2007.



Source: ACCC FD 2008, Gasnet applics

In its final decision in 2008, the ACCC:

- Allowed as capex $8.84m as reimbursement of corporate restructuring resulting from the takeover of Gasnet by APA
- After considering in its draft decision that there should be a $2m pa saving accruing to Gasnet as a result of synergies coming from the APA takeover, in the final decision, the ACCC considered that the savings should be part of the efficiency gain which should flow to consumers over time. On page iv of the final decision, the ACCC commented that it will allow

> "GasNet to retain any cost savings for a period of time after which any savings will be passed on to users."

Implicitly in the final decision, corporate overheads were included in the "base year" costs. In its allocation of costs included in table 5.2, Gasnet should have excised some of the ACCC allowance of labour, material and outside costs and attributed these to corporate costs cost. By not doing so the apparent ACCC allowance for corporate costs is understated. The EUCV approach to allocating costs for comparison purposes overcomes this problem, and shows what long term costs should be in terms of direct and indirect opex.

What this approach shows is that rather than consumers seeing lower costs as a result of the APA acquisition (to offset the strange inclusion in the AA3 capex of $8.84m to reimburse APA for acquiring Gasnet), the synergy benefits seem to have disappeared with Gasnet being lumbered with increased corporate costs from APA. This dispels the ACCC assumption that there would be savings from the synergies.

The chart of corporate and other costs shows that prior to the acquisition, these costs totaled about $10m pa. This amount included the costs of acquisition of equity, insurance, asymmetric risk and similar management costs for the business. Since the acquisition these costs have increased by over 50% despite the assumption lower costs would eventuate. The claim for AA4 further increases these costs to be about 80% above the efficient costs set in AA2.

The EUCV considers that the indirect costs should not increase in real terms as overhead costs are reasonably independent of expansions and growth of the network. On this basis the AER should only allow Gasnet the efficient costs for its indirect costs which were those which applied before the acquisition. To allow Gasnet increased indirect costs based on AA3 actuals denies consumers the benefits that the acquisition should have delivered and are necessary to offset the continued cost of the capital that the ACCC allowed in AA3 to reimburse APA for the acquisition.

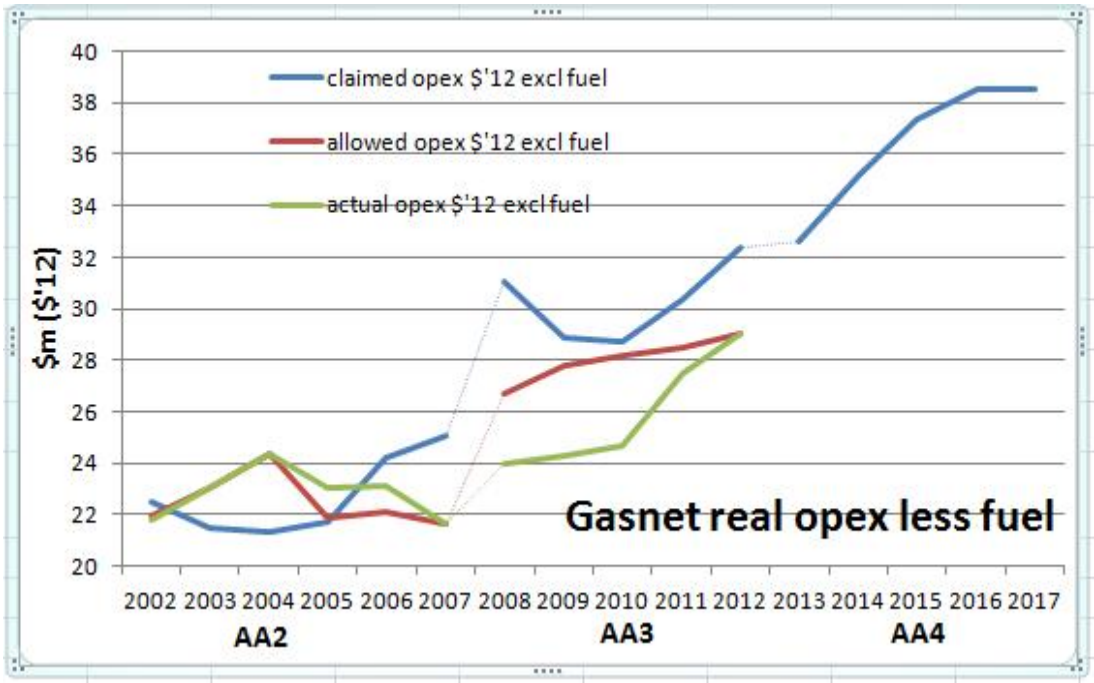
The EUCV is concerned that there is no demonstration that the corporate costs passed through to Gasnet from APA are neither efficient nor reflect the actual costs that might be applicable. The AER is only permitted to allow efficient costs to be provided to Gasnet under the Rules and this is why the EUCV referred back to AA2 to identify efficient indirect costs.

The approach used by APA to allocate costs in a non-transparent manner reflects a major issue for the regulation of networks where a significant portion of the costs for providing the service are attributed to a related party. The EUCV considers that the AER must delve deeply into the issue of indirect costs to ensure that they do in fact represent efficient costs.

3.3 Benchmarking

Other consumer groups have raised with the AER the need to use benchmarks to set opex allowances. The EUCV has sympathy for this view as industry wide benchmarking is the only tool which provides a regulator with the tools to assess the principle behind incentive regulation – that of competition by comparison. Unless a monopoly is compared to another as a core requirement to assess the reasonableness of a monopoly's claim, a regulator has little ability to impose the strictures of competition on the monopoly.

The AER has consistently used year 4 of a five year regulatory period as being efficient when there is an efficiency sharing scheme in place which the AER assumes drives the regulated firm to maximise efficiency. This is the approach used by Gasnet in seeking its opex allowance for AA4. What is apparent from the changes in opex over periods AA2 and AA3, is that the opex for year 4 of AA3 is considerably higher than the opex in earlier years as shown in the following chart.



Source: ACCC FD 2008, Gasnet applics

Actual opex for 2002 to 2010 is reasonably consistent in value, spiking for year 4 of AA3 and opex for year 5 of AA3 is forecast to be even higher.

To overcome this potential for gaming, the AER should apply some external benchmarking. This provides two useful outcomes:

1. It identifies if there has been some deliberate transfer of costs from early in the period to the later years, and
2. It identifies whether the firm has actually reached the efficient boundary which is the intent of incentive regulation. Unless a regulated firm is challenged, it has no incentive to strive for the efficient boundary because it may already consider it is at this point.

The AER should undertake, in addition to using past performance as a guide, external benchmarking of the Gasnet operations. This is particularly important when there are non-transparent related party charges being included in the allowances.

The AER relies on technical support to assess the reasonableness of an opex claim. This support to the AER is usually provided by engineering consultants who examine the costs from a “bottom up” approach. What external benchmarking provides is a “top down” assessment as to what is the most effective approach to assessing whether the allowances are at the efficient boundary.

The EUCV considers that self benchmarking coupled with the application of a STPIS for the last decade, should allow the AER to use self benchmarking as its primary tool for setting opex. External benchmarking provides a discipline to ensure that cost allowances represent efficiency.

3.3 The relationship between capex and opex

There is general agreement that there is a relationship between capex and opex, and the AER consultants and even some of the energy transport businesses have observed this. With the increase in capex for refurbishment, there must be a proportionate reduction in opex, as this is what justifies the replacement of old assets with new assets. Notwithstanding this inverse relationship, Gasnet proposes to increase its opex from current levels.

Where there is growth in a network there is an expectation that there would be additional opex attributable for new capex, but where capex is about replacing old assets with new, or replacing old with something new but larger, there is little justification for added opex.

The AER must recognise the inter-relationship between capex and opex, as far as the Gasnet application is concerned. It is a fundamental matter for any business that much of its capital it invests should result in a reduction in opex. The other reason for capex is to match increasing demand for products.

Gasnet has claimed an increase in capex, in part, due to escalation of costs. If this is the case than the commercial relationship between capex and opex becomes even more important. If the cost to replace the assets increases, then from a consumer viewpoint it is more economically efficient for the opex to be maintained rather than pay a higher cost as a result of new assets replacing old (ceteris paribas).

In section 2 above, it is pointed out that there is a commercial driver for Gasnet to replace assets rather than continue with incurring opex. It is the building block approach which provides this driver, as opex is recovered at cost, whereas assets achieve a return which provides the profits for the regulated business.

The AER must ensure that the capex used does result in opex being proportionately reduced.

3.4 Summary of opex cost

Gasnet has sought a step increase in opex from the current average allowed opex of 30% and an increase of 40% above the actual average opex. This step increase is excessive especially when it is considered that within the current actual opex a related party (APA) has levied a considerable increase in corporate costs above those applying when Gasnet was a standalone firm.

There is considerable long term consistency in the actual "direct" opex (labour, materials and outside services excluding fuel gas) and the step increase claimed of 64% in these direct costs is grossly excessive and not justified.

Gasnet incurred indirect costs (corporate and other) of some $10m (in real terms) before its acquisition by APA (ie in AA2). The ACCC allowed capex of $8.84m in corporate restructuring costs with an expectation that there would be synergy savings by 20% ($2m pa) from the acquisition yet these corporate and other costs increased in AA3 by 50% after the restructure. Gasnet is seeking a further increase of another 20% for AA4 In comparative terms the cost of corporate and other costs in AA2 of $10m pa will increase by 90% in AA4 to an average of $19m.

Overall the approach used by Gasnet to acquire considerable additional corporate costs needs to be examined in detail and this adjusted to an efficient level. The large step increases claimed in opex are excessive.

4. Forecasts gas demand and consumption and escalation

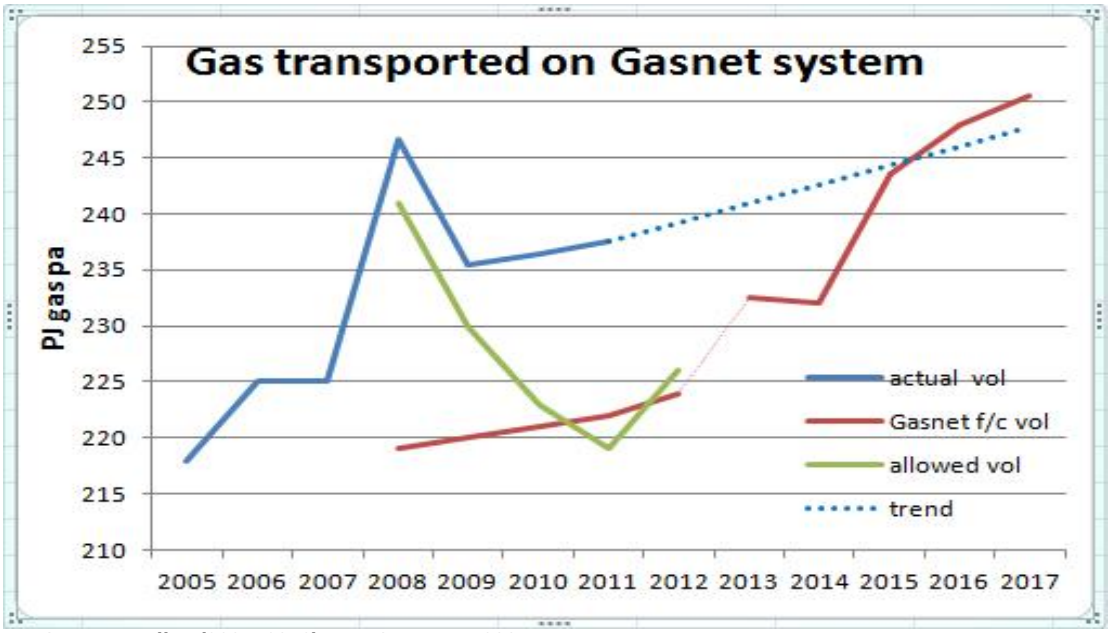
4.1 Gas demand and consumption forecasts

In the current period, there was more gas transported on the Gasnet network than was forecast for the five years of AA3. Table 5.1 in the Gasnet application explains what comprised the makeup of the gas transported and this shows that in addition to the demand of Victorian customers, transfers to NSW and replenishment of underground storage comprises up to 10% of the gas transported by Gasnet. Gasnet forecasts indicate that this percentage amount will apply for AA4.

Gasnet comments that it uses the latest AEMO gas usage forecasts for use in Victoria less that for gas powered generators (GPG) and states (page 61 of its application):

> "APA GasNet has therefore supplemented [the AEMO forecasts of gas used in Victoria] … with its own estimates of:
>
> - interstate gas transfers;
> - storage refill volumes; and
> - Annual and peak day volumes associated with gas-fired power generators."

The EUCV recognizes that interstate transfers, refilling and GPG usage must also contribute to the revenue Gasnet receives and therefore these volumes need to be included in the forecasts. The following chart shows the amounts of gas transported on the Gasnet system, accompanied by the Gasnet forecasts and the allowances made in the past.



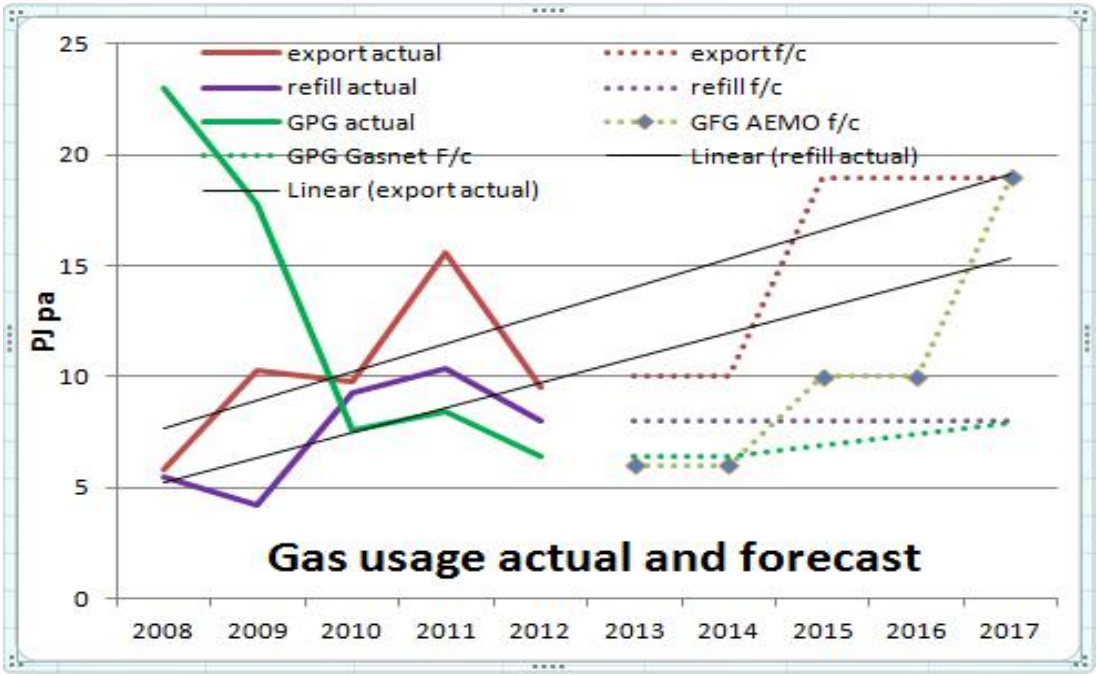
Source: Gasnet applics (2007, 2012), VENCorp APR 2007,

To some extent the chart explains why Gasnet over-recovered in its revenue because there was more gas transported than was forecast in the ACCC final decision in 2008. Analysis of the amounts of the over-recovery of revenue and the additional gas transported do not explain the entire amount of over-recovery.

What is also important to note is that the Gasnet forecast for gas transportation included in its 2007 application, shows a considerably lesser amount of gas to be transported than actually occurred. Therefore great care is needed to assess whether Gasnet has under-estimated the amount of gas expected to be transported for AA4 because the regulatory price cap approach incentivizes Gasnet to under estimate the amount of gas to be transported.

AEMO has forecast in its Victorian gas 2011 APR that gas usage within Victoria is increasing at an annual rate of about 0.7% pa. This growth is shown on the chart as a trend from the actual data from 2011. This trend line shows that the gas transported on the Gasnet system will be considerably less than the amount forecast by Gasnet until the end of AA4 period. Intriguingly, both AEMO and Gasnet are indicating that the amount of gas being transported in 2013 will fall below 2011 actual gas flow by some 5 PJ but t6here is little explanation as to why this might be the case.

The EUCV has quite severe concerns about the forecasts of gas usage for AA4, particularly considering that tariffs will be calculated on the forecast usage and therefore if the forecasts are too low, then this sets the potential for Gasnet to get a larger revenue than the AER considers is efficient. To identify why there might be differences, the following chart plots historic and forecast gas usage for exports, gas generation and gas refilling.



Source: AEMO gas APR 2011, Gasnet applic

What the chart highlights is that the actual growth trends for export and refill show significantly higher expectations of gas flows than is forecast by Gasnet. Further the expectation for gas used for power generation forecast by Gasnet is significantly less than that forecast by AEMO.

Further, AEMO has provided a forecast for gas usage by power stations and there is limited consistency between the AEMO and Gasnet forecasts for this except for the first two years. For the last three years the AEMO forecast is for nearly twice the amount Gasnet forecasts for gas used by power stations. The actual gas usage for each of the three uses along with the forecasts is shown in the following chart.

AEMO also forecasts in its Victorian gas 2011 APR that the daily demand for gas is increasing at about 0.7% pa on its medium assessment of growth. Daily gas demand is the main driver for capital expenditure and therefore this small growth forecast does not provide a significant driver for the capex allowance

Overall there is considerable doubt as to whether the forecasts for gas usage are too conservative and as a result liable to lead to an overstatement of gas tariffs for AA4

4.2 Escalation forecasts

Gasnet has provided a view that its forecasts for capex and opex are based on costs applying at 2012.

4.2.1 Movement in the price of materials

It appears that the changes in the cost of materials are to be accommodated within changes to the CPI adjustment. This decision by Gasnet raises an interesting aspect of regulatory practice. It appears that when prices are likely to be higher in the future than would be accommodated within the CPI adjustment, the regulated firm is permitted by the AER to claim (and be granted) an increase in the allowance. However when future escalation in prices is seen likely to be less than what the CPI adjustment provides, then the firm can elect (and be allowed by the AER) to garner a better outcome by not seeking escalation adjustments. This approach is quite one-sided. On the one hand the regulated firm is provided with protection against rising prices related to their business but when these related prices are considered to fall (or be less than CPI) then there is no adjustment.

Either way, consumers are worse off. They see increased costs because prices particular to the firm are rising faster than CPI, but no benefit when prices particular to the firm are falling. This can be stated quite simply – heads the firm wins, tails the consumers lose. The AER should review this aspect to ensure there is greater equity for consumers.

4.2.2 Movement in the cost of labour

Gasnet has advised that its labour costs are related to EGW for direct labour and construction labour for large elements of the capital works.

Gasnet has advised that it considers the best indicator of labour cost movements is by using the Average Weekly Ordinary Time Earnings (AWOTE). The AER has consistently used productivity adjusted Labour Price Indices (LPI) and has provided extended dialogue as to why it considers this the better way to provide for regulatory adjustment of future labour price movements.

To support its arguments Gasnet has provided additional data about its enterprise agreement which is not publicly available. The EUCV does not consider that a regulator should adjust costs to relate to future cost changes that have been negotiated by a single firm. This does not necessary reflect an efficient outcome and provides a bias towards higher labour costs than might occur under a more independent approach.

For example, if the AER allows the enterprise agreement to be used to set the future costs, this provides the Union with a clear signal that whatever labour cost movements are agreed will be rolled into the next regulatory decision. If this occurs, the firm has no strong driver to negotiate the lowest possible price for labour. If the AER uses an independent assessment of expected labour price movements, then the firm has a driver to negotiate a

lower price for labour as this would provide a benefit to the firm. It does not lead to an efficient outcome where both parties to a negotiation are aware that whatever is agreed the cost will be borne by a third party.

The AER and APA Group subsidiaries have had a long running debate as to whether AWOTE or LPI provides a better forecast of future labour costs, and this issue has been raised at every reset involving APA Group subsidiaries. This debate has now been picked up by others not related to APA Group. The AER has consistently provided a strong case as to why the LPI adjustment is a better indicator for future labour cost movements and the EUCV cannot add to these. The EUCV does support the AER in its continued use of productivity adjusted LPI.

What these and APA have all failed to recognize is that consistently the outcome of using LPI has not disadvantaged the regulated firm because consistently, actual opex costs have, over time, been less than the regulated allowance. On this basis alone, there is no sound reason for the AER to vary from its present practice of using productivity adjusted LPI to forecast future labour cost changes.

The reason that regulated firms seek to use AWOTE is that this appears to give a higher cost forecast than LPI and would therefore provide the regulated firm with a larger profit.

Gasnet advises that, although it does not consider that the forecasts of labour cost movements should be productivity adjusted because this is not consistent with the principle of incentive regulation (which Gasnet observes allows the regulated firm to hold productivity improvements until the next reset) Gasnet accepts that the forecasts of labour movements can be productivity adjusted. The EUCV disagrees with Gasnet's reasoning but agrees that they should be adjusted for productivity.

5. Cost of capital and allowed revenue

5.1 Weighted average cost of capital (WACC)

In the recent reviews of network resets, there has been advice from the applicants that there is a need to set the WACC parameters to values that provide an increase in the WACC or a reduction of the amount of tax that is subject to imputation. Considerable effort by applicants has been devoted to "drilling down" into available data to "prove" that changes are required to provide a WACC that reflects "reality". What no one, including the AER, has done is to assess whether the outcome of the various levels of WACC calculated are efficient and reflect an outcome that provides an efficient WACC – one that provides an adequate return to the network provider but neither over provides nor under provides when compared to what occurs in the competitive market.

This view is supported by the Chair of the AEMC, Mr John Pierce, who is reported as stating[7]:

> "You've got to have the right rate of return. The first question is, what's the minimum rate of return necessary to attract funding so people will invest in the sector. Secondly, we want people to operate efficiently so what we need is an efficient benchmark rate of return… we want them to try and beat it so the shareholders get the benefit of it, so that next time around it can be shared with customers.
>
> ''But if they don't … then you also want the shareholders to suffer … if I'm inefficient, I want the shareholders to carry that risk, not customers."

Some of the claims made by applicants have ultimately been referred to the Australian Competition Tribunal (ACT) for a ruling. In the case of imputation the ACT has determined the proportion of dividend subject to imputation. The ACT has also been heavily involved in the way the AER has to use scarce publicly available data on the values of Australian corporate bonds in order to manipulate minimal data into a form which might be used to infer a debt risk premium for the benchmark BBB+ rated entity.

The AER in its WACC decision in 2009 for electricity transmission networks provided values for the market parameters, viz, a risk free rate based on 10 year CGS, a market risk premium of 650 bp, an equity beta of 0.8, a gamma of 0.65, gearing of 60% and a credit rating of BBB+. Since then there have been AER decisions which reduce the market risk premium to 600 bp and the ACT has reduced gamma to 0.25.

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[7] "High power rates: it's a poles and wires story", SMH *June 12, 2012*

The applications from the DBs have accepted some of the parameters and sought an increase in the market risk premium to 844 bp. In addition, they has also commented that it is reviewing the averaging period for the risk free rate and provides considerable argument to set a debt risk premium of 392 bp.

It is obvious that the recent low yields for 10 year CGS has raised concerns with all the DBs as they provide considerable evidence that a long term 10 year CGS has a much higher value (by some 200 bp) than the current levels experienced. As a result the DBs argue that either the long term average 10 year CGS should be used as the basis for the CAPM calculation, or that higher levels of market risk premium should be used to accommodate what they consider to be a disparity in the calculations for the equity and debt components of the WACC that arises from a low risk free rate.

What concerns consumers is that such an approach is "all one way" as when the approach used by the AER has resulted in levels of debt risk premiums well in excess of actual costs, the regulated businesses have not sought lower levels – in fact they have actively sought, through the ACT, for even higher levels to be used. After enjoying the benefits of a financial market that has resulted in higher levels of WACC than was incurred, it is therefore somewhat perverse to seek a significant change in the approach to setting the WACC parameters because the outcome of the previous approach is not as attractive.

In its responses to the WA Economic Regulatory Authority (ERA) in response to its Draft Decision n Western Power, the WA Department of Finance made the following observations[8]:

> "The Authority's attention is also drawn to the risk of using a 20 day average to calculate the risk free rate given the significant degree of uncertainty and volatility in international financial markets at present.
>
> Given the turmoil in the financial markets emanating from Europe at the moment and the cascading effect that has on international financial markets, it would seem risky to base a five year WACC determination on a 20 day average in this environment.
>
> The Authority is therefore requested to consider this matter further in its deliberations and determine what would be a more appropriate averaging period that ensures Western Power is not 'locked in' to an artificially low return on its assets for the entire five year regulatory period, as a result of this current market volatility."

[8] Page 2 Dept of Finance submission to ERA dated 29 May 2012 available at http://www.erawa.com.au/3/1181/48/_western_powers_proposed_revised_access_arrangemen.pm??utm_source=ERAwebsite&utm_medium=HTML&utm_content=TextLink&utm_campaign=MostViewed

However this view to change the approach used for over 15 years to setting regulated WACCs is then undone when the Department then seeks for the ERA to

> "…to consider the importance of regulatory certainty and how it impacts Western Power and indirectly, its end consumers."

Regulatory certainty is at the very basis of the AER Statement of Regulatory Intent (SORI). To vary from the longer term practices introduces uncertainty, so the AER has to be cognizant of the risks inherent in changing regulatory practices because the wider financial environment has changed. The AER maintained its flawed practices for setting the debt risk premium (which benefited the regulated firms) despite clear evidence that the financial environment had changed. The AER decision to continue the use of the flawed process (coupled with successful appeals from regulated firms) delivered considerable harm to consumers and increased profits to the regulated firms.

In its recent draft decision on Western Power the ERA decided to use the 5 year CGS rate, an MRP related to the 5 year CGS of 600 bp, an equity beta of 0.65, a credit rating of A-, a shorter borrowing term than 10 years to reflect actuality of the debt portfolios seen in the market[9] and less reliance on the Bloomberg data.

This revised approach has tended to reset the calculated WACC to a level which more reflects what actually is occurring in the wider market and results in WACCs which are more reflective of what is seen in the wider market.

Whilst the ERA decision is, at the time of preparing this submission, still at draft stage, the arguments included in it are very detailed and provide totally different conclusions to those that Gasnet and its consultants provide.

It is important to note that the Gas Rules are not as prescriptive as the Electricity Rules in regard to the development of the WACC to be used by regulators. Intriguingly, the ACT has also made observations that the approach used by the AER in developing the debt risk premium can be contentious and that other approaches to its development could be used.

In its application, Gasnet provides an excerpt from the Gas Rules

Rule 87 (Rate of Return) of the NGR:

[9] This approach has the added benefit of increasing the population of corporate bonds to provide greater reflection of the actual costs.

(1) The rate of return on capital is to be commensurate with prevailing conditions in the market for funds and the risks involved in providing reference services.
(2) In determining a rate of return on capital:
    (a) it will be assumed that the service provider:
        (i) meets **benchmark levels of efficiency**; and
        (ii) uses a financing structure that meets **benchmark standards as to gearing** and other financial parameters for a going concern and reflects in other respects **best practice**; and
    (b) a well accepted approach that incorporates the cost of equity and debt, such as the Weighted Average Cost of Capital, is to be used; and a well accepted financial model, such as the Capital Asset Pricing Model, is to be used. (emphasis added)

This wording provides the AER with significant flexibility to develop a WACC which delivers a sensible outcome that is more reflective of the wider market than the mechanistic approach currently used by the AER, although the EUCV acknowledges that the AER approach does provide regulatory certainty which is also a feature of the Australian regulatory environment. In particular, the EUCV draws attention to the requirement that the outcome is to meet benchmark levels of efficiency, benchmark standards as to gearing … for a going concern", and reflects "best practice".

It is also important to define what is "efficient". The second reading speech for the introduction of the National Electricity Law defines efficiency as being when

> "…services are supplied in the long run at least cost, resources including infrastructure are used to deliver the greatest possible benefit and there is innovation and investment in response to changes in consumer needs and productive opportunities."[10]

The regulatory approach used in Australia is based on incentives, so that the providers will actively seek to make its operations more efficient and for these savings to be passed onto consumers in the long term. This means that the first assessment of the regulator is to identify how the regulated firm has improved its efficiency and for these efficiencies to be built into the future allowances. The second stage of ensuring efficient outcomes, is for the performance of the regulated firm to be benchmarked against "best practice" seen in the provision of the services.

This means that, particularly under the Gas Rules, the AER is required not just to use approaches that it has used in the past, but to actively recognize

[10] Hansard, SA HOUSE OF ASSEMBLY, Wednesday 9 February 2005, page 1452

what is “efficient” and “best practice” so that the long term interests of consumers are integrated into each regulatory decision.

It is clear that Gasnet has decided to only query WACC parameter inputs where they consider there might be an argument to justify higher values, and to not query any inputs where there might be an argument to reduce the values set in the AER WACC review or by other regulators. In its submissions to the AER on the WACC review, the MEU (on behalf of its affiliates and the Consumer Roundtable) pointed out that there is a high degree of interdependence between the various inputs, and therefore an holistic approach is necessary to setting the WACC inputs. By and large the AER concurred with this view and its workings show this feature in many instances. The approach by Gasnet effectively negates the concept of a holistic overview, and therefore if the AER decided to open up this debate, it should also decide that other input elements should be investigated and perhaps changed.

As the Gas Rules require the outcome to be efficient and reflect best practice, the AER must assess all aspects of the WACC development so that the outcome complies with the Rules.

5.1.1 Term of the outlook and risk free rate

The decision to use a 10 year outlook for setting parameters and inputs to the WACC was a result of the ACT determining that if the market risk premium was calculated from the difference between the ASX accumulation index and the 10 year CGS, then the 10 year CGS should be used as the risk free rate. This decision came because the ACCC had previously used the 5 year CGS as the basis for the risk free rate and the MRP developed from the 10 year CGS.

The draft decision by the WA ERA makes a sound case for the 5 year CGS to be used as the risk free rate and this would be combined with an MRP calculated over time from the ASX accumulation index and the 5 year CGS. The ERA then was able to have a much larger population for setting the debt risk premium as the DRP would reflect a five year outlook.

As well as having a number of implicit benefits from using data from a 5 year outlook, the ERA highlights that the regulatory period being examined is for 5 years, and therefore the best outlook for setting the WACC for the regulatory period is to use data that coincides with the regulatory period. It is essentially inconsistent to set a WACC based on data for the next ten years but which will only apply for the next five years. It is logical that the WACC for the next five years be based on input reflecting that period. It was this same argument that led the ACCC to use the 5 year CGS in its earlier decisions.

The ERA approach reflects considerable consistency and common sense. The EUCV considers the AER should implement such an approach, accepting that the Gas Rules not only allow for the WACC development to follow such an approach if it is considered to be efficient and reflect best practice. The ERA approach reflects efficiency because it ties the WACC to the duration of the regulatory period and is thus internally consistent.

It would be more efficient to use data applying to the next five years to set a WACC for the 5 year regulatory period, as this is more reflective of the costs that are likely to be incurred over the duration of the reset period. Such an approach also reduces risks for the regulated entity, knowing that the data used is consistent with the period for which it is to apply.

5.1.2 Gearing

The Gas Rules require the WACC to be efficient and reflect best practice. The AER has determined that the model energy transport firm would be geared to 60% debt and 40% equity, and that this would provide a credit rating of BBB+ against which the firm would secure its debt funding.

Analysis of the gearing of the four gas transport businesses in Victoria indicates that best practice for gearing lies between 65%-80% debt[11] with a weighted average of between 70-75%. Incentive regulation is intended to provide firms with the opportunity to develop the most efficient outcome based on best practice. This means that the firms themselves have identified that a better (more efficient) outcome is with a higher debt than the 60% used by AER. This implies that best practice is a higher debt level than 60%.

It is interesting to note that even with this higher gearing, all of the four gas transport firms in Victoria are able to secure their debt at costs considerably below that allowed by the AER in its most recent gas transport decisions (NT Gas which is also owned by APA Group and Envestra SA and Qld), implying that 60% gearing is not associated with BBB+ credit rating but probably a higher rating, a conclusion reached by ERA.

A review of the latest annual reports of the four gas businesses in Victoria shows the following gearing levels. Also included in the table is the current credit rating of each.

[11] SP Ausnet (owner of Victorias western gas distribution assets) is geared to 66% debt, APA (owner of Gasnet) to 69%,, DUET (owner of Multinet) to 80% and Envestra to 81%

Actual gearing	Credit rating[12]	Debt/ Assets
APA (Gasnet)	BBB	69%
DUET (Multinet)	BBB-	80%
SP Ausnet	A-	66%
Envestra	BBB-	81%
Arithmetic Average	BBB	74%

The EUCV considers that the gearing of an efficient gas transport business operating at best practice is probably 70% or higher, and the AER should be using this gearing for the Gasnet WACC calculation

The Rules are clear that in:

> "… determining a rate of return on capital … it will be assumed that the service provider …uses a financing structure that meets benchmark standards as to gearing … for a **going concern** and reflects in other respects **best practice**" (emphasis added)

The AER has previously decided that the benchmark standard for gearing is 60% and that this reflects best practice. That none of the Victorian gas businesses (all "going concerns") has gearing at 60% (and most other regulated energy networks in the country exhibit gearing at a higher level than 60%) indicates that best practice has gearing at a considerably higher level than the 60% used. A value of 60% is demonstrably not efficient as the businesses all have a higher level of gearing yet do not appear suffer considerable credit rating downgrades.

What is also obvious from the data is that a gearing level of 60% does not match a credit rating of BBB+. SP Ausnet has a gearing of 66% and a credit rating of A-. Averaging the four businesses indicates that a credit rating of BBB (one level below BBB+) would appear to be related to a gearing of 74%.

The AER has the responsibility under the Rules to set the gearing which is best practice and which is efficient. If all four businesses demonstrate a higher gearing than the 60% used previously by the AER and all are "going concerns", then this indicates that higher gearing is "best practice" The fact that at this higher gearing the benchmark credit rating of BBB+ is exceeded, indicates that a higher gearing is more efficient.

The Rules do not expect that the AER will use gearing which does not reflect best practice or is not efficient. The EUCV considers that gearing at 70% reflects best practice and is more efficient than gearing at 60%.

[12] Sourced from ERA draft decision on Western Power Table 71, page 174

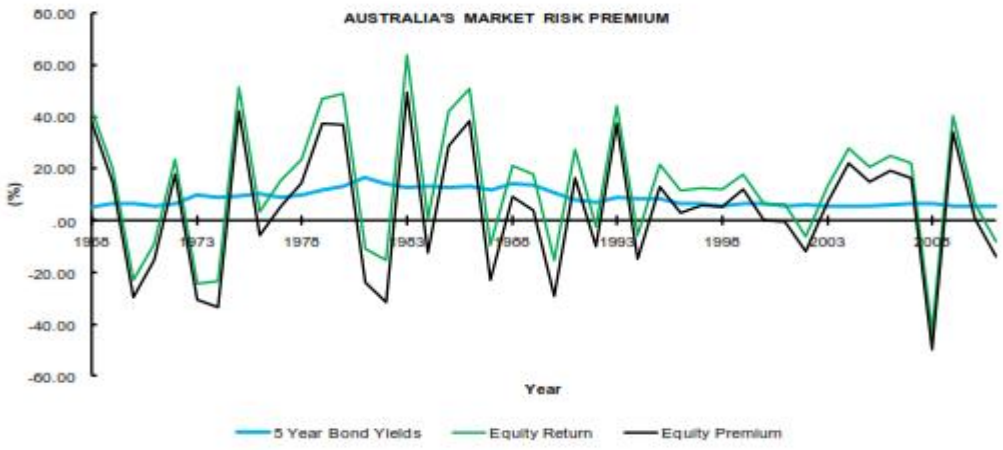
5.1.3 Market risk premium

In its draft decision ERA recalculated the market risk premium over considerable periods of time against the 5 year CGS and calculated that the MRP on this basis is 600 bp. Over the past 20 years, the 5 year CGS has been consistently lower than the 10 year CGS by at least 25 bp. That ERA identified that the MRP when measured against 5 year CGS is 600 bp, then against the 10 year CGS the MRP must be at most 575 bp.

This conclusion is at odds with the claim by Gasnet and its consultants that the MRP should be set at 850 bp against the 10 year CGS. There is a clear inconsistency between the views of Gasnet and ERA.

The EUCV has long been of the view that the MRP varies on a yearly basis (and even on a shorter time basis). During the later stages of the global financial crisis (GFC) for example, the ASX accumulation index was negative for a considerable period whilst the 10 year CGS was quite positive implying a considerably negative MRP. Before the GFC, the accumulation index was markedly higher than the 10 year CGS implying a larger MRP than the average. This variability is demonstrated by the following chart (figure 9) extracted from the ERA draft decision for Western Power (page 163)

Figure 9 Australia's Market Risk Premium, 1968 – 2011, Per cent



Source: RBA, Bloomberg, and Economic Regulation Authority's analysis

A regulator needs to ensure that the WACC it determines reflects the longer term and avoids the quite large swings in MRP estimates that result from quite massive swings on the share market. It is therefore possible at any point in time to select a period of calculation of MRP that will return a higher MRP than the long term average but, equally, selecting another period might result in a negative MRP. Thus, it is essential that for the sake of consistency, MRP must be calculated over

a period long enough that significant swings are eliminated. This is what the ERA did.

Regulated firms were supportive of the AER increasing the MRP in the depths of the GFC because the outcome increased their WACCs at a time when there was great uncertainty. The result of this move was to over-provide a rate of return for a considerable period and provide an unearned and unnecessary benefit to regulated firms. Quite sensibly the AER reduced the MRP when stability returned to the market as a whole and it was seen that the WACC based on an MRP of 650 bp was then providing a WACC that was excessive. Such an approach reflected the requirement for setting an efficient WACC based on best practice – both aspects that are explicitly required by the Gas Rules.

Prima facie there does not appear sufficient new evidence to support the Gasnet contention that MRP should be raised at all, let alone to 850 bp. The ERA analysis implies that in fact the MRP (compared to 10 year CGS) should be lower than 600 bp.

5.1.4 Equity beta

Gasnet has not requested an increase in equity beta, considering that the recent AER decision on NT Gas on equity beta of 0.8 had rejected a strongly presented argument for increasing this parameter to be 1.0. In fact the AER WACC review (page 343) had identified that equity beta, based on:

> "The empirical evidence considered by the AER suggests that the equity beta of a benchmark efficient NSP is in the range of 0.41 (average portfolio estimated by the AER for Australian businesses post 'technology bubble') to 0.68 (average portfolio estimated by the ACG for the JIA using a five-year estimation period)."

This empirical evidence carried out for the WACC review implies an equity beta of 0.55. Interestingly the ERA draft decision for Western Power suggests that the equity beta should be 0.65.

The ERA used the same processes as were used for the AER WACC review to estimate the equity beta but used an extra three years of data.

In the final decision in regard to the gas distribution firms released in March 2008 by ESCoV, the ESCoV commented (after considerable investigation) that:

> "The Commission has therefore considered that in the application of the preferred methodology the evidence concludes that:

- the beta estimates obtained using the longest period of data range between 0.5 and 0.7 depending on the method (outlier adjustment) applied
- the beta estimates obtained using the most recent five-year period would indicate that the range may extend below 0.5 however
- the US evidence suggests that the beta is between 0.6 and 0.8."

After considering each of these points, the ESCoV set equity beta for the gas distribution networks at 0.7[13]

The EUCV considers that the work carried out by ESCoV (and applied to the gas distribution networks at the last review) clearly indicates that an equity beta of 0.8 is too high. The more recent work by ERA using three years of additional data led them to the conclusion that the equity beta should be 0.65

The EUCV considers that at most the AER should be consistent with the ESCoV decision and retain an equity beta of 0.7 rather than increase it to 0.8 which it has applied in other recent decisions.

But the EUCV considers that the more recent work by ERA using additional data than that used by the AER at the WACC review provides persuasive evidence that the lower equity beta value of 0.65 should be used, as this results from the most recent assessment of this parameter and uses more data than that used previously by the AER.

The AER is required to ensure that the WACC it develops is efficient. It is not efficient to use a value for equity beta which is patently much higher than it need be.

5.1.5 Debt risk premium

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

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

[13] The ESCoV also set the equity beta for the water businesses in 2009 at 0.65, based on the work it carried out for the 2008 gas distribution review. The final decision noted that there was little data available for water businesses and the gas businesses provided a reasonable surrogate

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

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

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

The EUCV has reviewed the annual reports of the four privately owned gas network firms operating in Victoria. The outcome of this review is tabulated below[14] providing the actual DRPs (compared to the 10 year CGS) for the parents of the Victorian gas transport businesses.

Actual DRP (bp)	Credit rating[15]	Debt/ assets	2008	2009	2010	2011	Av'ge
ACCC allowed			299	299	299	299	299
ESCV allowed			215	215	215	215	215
APA (Gasnet)	BBB	69%	100	310	240	300	235
DUET (Multinet)	BBB-	80%	80	160	190	200	160
SP Ausnet	A-	66%	-50	80	60	50	35
Envestra	BBB-	81%	150	330	220	290	250
Arithmetic Average	BBB	74%	70	220	180	210	170

This EUCV analysis provides some interesting observations:

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

[15] Sourced from ERA draft decision on Western Power Table 71, page 174

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

The Rules are clear that in determining:

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

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

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

The Gas Law and the Gas Rules are specific that the costs allowed a service provider are to be efficient. To award a debt risk premium that is

demonstrably not efficient is not in accordance with the Law or Rules and the AER must deny the approach proposed by Gasnet and implement an approach that does deliver an efficient outcome.

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

5.1.6 Gamma

Gasnet has used the same value for gamma that was set by the ACT after an appeal.

The EUCV does not have available data which would provide persuasive evidence that the ACT decision is incorrect, but does make the point that the value of 0.25 set by the ACT implies that imputation at this level probably would make the decision by Government to show a marginal benefit at most when considering the costs involved in managing imputation. That Government has not repealed the Laws imputation implies that it considers that the benefit of imputation is considerably greater than that implied by the ACT decision.

5.1.6 Summary of parameter values

The EUCV considers that the parameters that should be used for the WACC should be:

Parameter	Gasnet	EUCV
Risk free rate	10 year CGS	5 year CGS
Gearing	60% debt	70% debt
MRP	850 bp above 10 year CGS	600 bp above 5 year CGS
Equity beta	0.8	0.65
DRP	392 bp above 10 year CGS	195 bp above 5 year CGS
Gamma	0.25	0.25

5.2 WACC for speculative investment

For speculative investment, Gasnet seeks all parameters to be the same as for conforming investment but an increase of equity beta from 0.8 to 1.20.

The EUCV agrees that there is an increased risk that speculative investment might face and that a higher equity beta is reasonable. However as the equity beta for the market as a whole is notionally 1.0, the risk for

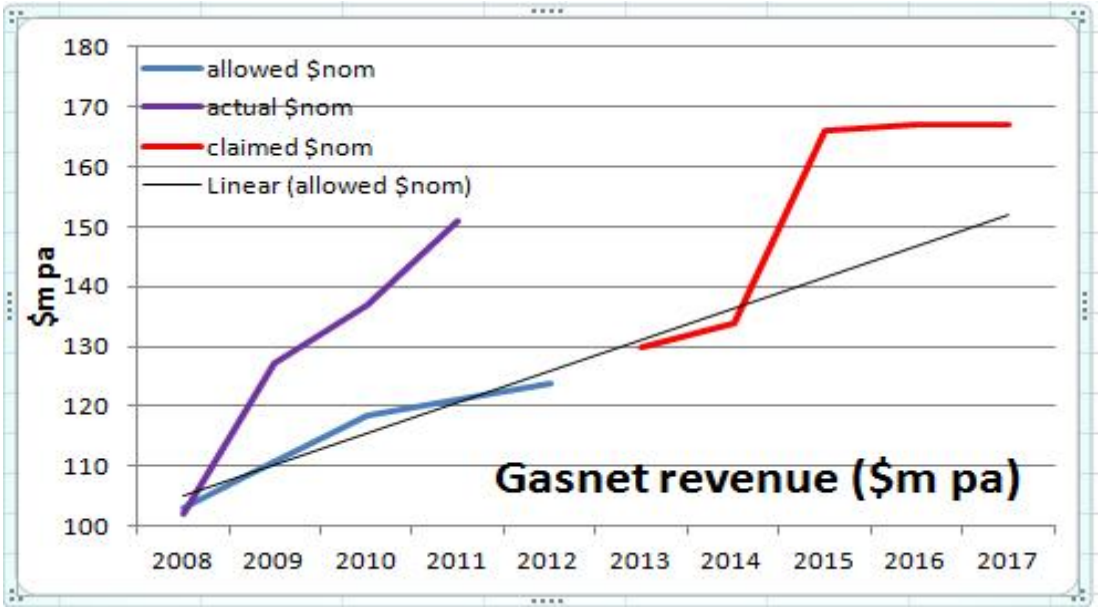
speculative investment reflects a similar risk profile that the competitive market faces.

In fact, although speculative investment might be unlikely to recover the full value of the investment in the short term, the potential for Gasnet to receive full value for the investment at some point in the future is much greater than that of the market as a whole, because Gasnet has an effective monopoly franchise on gas transmission in Victoria. When considered in this light, Gasnet faces a lesser risk than the market as a whole for speculative investment, implying a lower equity beta should apply than the entire market especially as some of the investment associated with the speculative investment might be automatically included in the asset base[16].

On balance the EUCV considers that the equity beta for the speculative investment should lie in the range of 0.8 to 1.0.

5.3 Revenue allowed and the impact on consumers

Gasnet has sought a revenue that shows a marked increase from the revenue currently assessed in the current AA3 period. The actual revenue achieved, the allowed revenue for AA3 and the sought for AA4 in the Gasnet application are shown in the following chart



[16] For example, if an augmentation requires a 100 mm diameter pipe and Gasnet concludes that a 150 mm pipe might be needed in the near future, there are two scenarios that the AER might consider. That the 150 mm diameter pipe is prudent (and therefore not speculative) or that the cost for the 100 mm diameter pipe is not speculative and the balance of the cost to provide 150 mm diameter pipe is speculative. In this second case, the bulk of the cost is considered to be prudent and the balance speculative.

Source: APA Group ARs[17], ACCC FD 2008, Gasnet application

The fact that the basis for the current period (AA3) has allowed Gasnet to significantly exceed its allowed revenue implies that the ACCC decision in 2008 provided Gasnet with an ability to achieve this outperformance and so increase its profitability. Whilst there is a 25% increase in revenue for 2011 above the revenue allowed, there are no obvious reasons for this large increase in revenue other than a modest increase in gas transported which Gasnet forecasts will be less than 1% pa. The ACCC decision in 2008 did allow an increase in revenue at CPI + 2.8% over the period of AA3 but the modest higher gas usage than that forecast does not result in the considerable over-recovery experienced.

At the same time, Gasnet also significantly underspent in terms of opex, capex and the cost of debt acquisition further increasing its profitability. In particular, the provision of the fuel gas was excised from the opex and paid by consumers as a pass through amount

Within the allowed revenue was a significant allowance for capital works that did not eventuate (particularly in the area of refurbishment) and savings in the major capital works (Northern Augmentation) although were identified and implemented. Despite this "over allowance" of capex and opex in the current period, Gasnet appears to be of the view that the current level of allowed revenue is appropriate for the next period and that a major increase is required in the middle of AA4 to accommodate a very large "reliability" project.

There is significant concern about the Gasnet claim for increased revenue when compared to the modest increase in gas transportation forecast. The AER must analyse why the actual revenue has increased by so much despite such small increases in gas flows. With the lack of information about where the additional revenue was generated, the EUCV cannot ascertain how such an increase occurred unless the way Gasnet set its tariffs permitted this over-recovery. The AER must establish the cause of this over-recovery and take steps to eliminate this in AA4.

5.4 Pass through events

Gasnet has sought an increase in scope of the causes leading to the AER permitting costs to be "passed through" to consumers. The use of "pass throughs" is a mechanism for the regulated entity to reduce its risk by passing these onto consumers. Regulators have been inclined to accept this approach as they (rightly) fear that an allowance in the costs to accommodate this risk might be too high. However, there is a need to

[17] As noted in section 1.3, the Gasnet compliance report indicates that higher revenues were achieved in 2008 and 2009, but as there was no similar data in the later compliance reports, this analysis is based only of the segment information provided in annual reports which show lower revenues achieved.

ensure that this transfer of risk is minimized and that the equity beta adjusted to reflect the reduced risk.

Gasnet has not suggested that the equity beta should be reduced to reflect the increased allowance for pass throughs included in the Gasnet proposal.

Gasnet has retained the pass through for changes in tax and regulatory events, although the wording in the new proposal would appear to expand the scope of these. In the case of the insurance events, the scope has been expanded and natural disaster and carbon cost events have been added.

The EUCV notes that the increased pass throughs include for counterparty default events (which the ACCC had agreed to for AA3) but Gasnet has added an insurer credit event as well. The EUCV does not consider that either of these should constitute a pass through as both of these defaults fall within the normal business risks. They are not risks unique to gas transportation and are therefore included in the market risk premium as risks of normal business operation.

Gasnet has retained the fuel gas pass through but the EUCV considers that there needs to be some control on Gasnet to ensure that the consumption of fuel gas is minimized rather than allowing uncontrolled pas through.

Gasnet has added a natural disaster event, but which Gasnet does not have insurance. Before such a pass through is allowed, Gasnet should be required to provide as much insurance and to undertake as much protection of assets as is reasonable for the business before any such pass through should be permitted.

The EUCV notes that Gasnet has added a carbon cost event to the list of pass throughs. The EUCV does not agree with this as the cost of carbon (under the Clean Energy Act) is embedded as a cost to providers of gas for combustion and is therefore required to be in the price Gasnet pays for fuel gas and is passed through. Other cost impacts of the cost of carbon will be buried in the price of assets acquired, so the EUCV does not see where such a cost of carbon might impact directly on Gasnet. Retention of this pass through will provide Gasnet with an opportunity to seek recovery of costs that it recovers in other ways.

6. Pricing Methodology

Under a price cap regulatory approach, the network takes the risk on the amount of energy that flows in the network. Gasnet is subject to price cap regulation, and this incentivizes Gasnet to maximise its allowed revenue and to understate its expected gas volumes. As has been seen in AA3, there was more gas transported than was assumed in the development of the Gasnet tariffs and therefore Gasnet would be entitled to a larger revenue recovery than was forecast by the ACCC in its 2008 Final Decision. That Gasnet achieved more revenue than would be expected after adjusting for the higher volumes of gas does not explain fully why Gasnet revenue was so much more than was expected.

The fact that Gasnet has enjoyed a significant over-recovery of revenue even though the higher amount of gas transported was not sufficient to explain the much higher revenue implies that its tariff pricing is biased to allow this over-recovery. Great care is needed by the AER to ensure that the tariffs it agrees to are cost reflective. If this is not done, there is potential for Gasnet to again significantly over-recover on its revenue.

The data provided by Gasnet in its application is insufficient for the EUCV to identify which tariffs are not cost reflective and permit this significant over recovery. The EUCV considers that the AER must devote resources to identify why there was this over-recovery and the mechanisms used to create it.

A major concern that the EUCV has regarding cost recovery is that gas exported into other gas regions (eg into NSW and SA) does not pay its fair share of costs for the transport within Victoria that is incurred when exporting that gas to other regions. This aspect is of particular concern where Gasnet is forecasting a considerable capex need to increase the delivery of gas for export via Culcairn. In principle, the approach of setting injection and delivery charges coupled with zonal transport charges should provide some degree of cost reflectivity so that interstate gas users do not get a “free ride” on investment paid for by Victorian gas users.

The EUCV is concerned that cost reflectivity has not been properly applied in the setting of the different tariffs and that this is the main reason for the over recovery of revenue. The AER must ensure that this aspect is rectified for the next regulatory period AA4.