Energy Users Coalition of Victoria

Australian Energy Regulator

Victorian Gas Transmission Revenue Reset

Draft Decision

By

AER

A response

by

Energy Users Coalition of Victoria

January 2013

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.

CONTENTS Page

Executive Summary

The Energy Users Coalition of Victoria (EUCV) welcomes the opportunity to provide comments on the draft decision addressing the application from Gasnet for 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 EUCV welcomes the AER's draft decision, as it has made a good start in winding back the ambit claims from Gasnet. However, much more needs to be done in winding back the unjustified cost claims, especially in light of Gasnet's revised application.

The EUCV considers that, where the AER has the discretion, it must be exercised in accordance with the National Gas Objective. In particular, in relation to setting the rate of return, the AER is in error should it rely on its regulatory principles to take precedence over the Objective, and not set the rate of return at a level that is economically inefficient. The AER will also should be in error should it accede to Gasnet's application for higher value for the MRP and the DRP. As this submission argues

> "Just as the AER has refused to accept changes to the setting of the DRP, so must it refuse to make a change to setting the MRP until the entire approach to setting regulatory rates of return has undergone the formal processes already in train." (EUCV submission page 30)

The EUCV also submits that:

- The AER draft decision to reduce the capex allowance to be in line with the actual capex used by Gasnet in AA3 is not only correct, but ot must also reject the revised application claim for increased capex allowances, particularly the augmentation proposal at Culcairn, as it is not demonstrably prudent.

- The AER draft decision on opex is far too generous, particularly as it is not acceptable that the GasNet overhead and "other" costs should be allowed to beincreased at all from the 2011 benchmark costs, which have been inflated by a massive 50% increase over costs actually incurred in AA2.

- The AER should apply the latest AEMO 2012 GSoO/ACIL Tasman forecasts of gas demand. Intriguingly, the EUCV notes that Gasnet has revised its forecast volumes of total gas to be transported down by ~10%, whilst at the same time increasing its forecast of gas flows to Culcairn. This juxtaposition needs close assessment by the AER.

- the AER should maintain regulatory consistency in its treatment of the GasNet application and continue to utilize its historic approach to depreciation.

Further details are provided in the EUCV's submission

1. Introduction

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

1.1 AER discretion and the Objective

The EUCV has reviewed the AER commentary on what the requirements of the National Gas Law (NGL) and the National Gas Rules (NGR) impose on the AER as it performs its regulatory review and determination in regard to the application and revised application by GasNet for setting the allowed revenue and reference tariffs for the next 5 years. The EUCV does not disagree with the AER assessment but does highlight some issues that the AER does not address.

Both the NGL and NGR allow the AER significant discretion in the performance of its regulatory role, which is in stark contrast to the limited discretion afforded the AER under Chapter 6A of the National Electricity Rules.

As a matter of principle, the AER must, where it has the discretion, exercise this in relation to the National Gas Objective (NGO) so that the AER is undertaking this review in the "long term interests of consumers". This means that even if the AER has established principles that it uses for its regulatory processes, if these principles do not result in an outcome which is in the "long term interests of consumers" then the principles are inappropriate and must be amended accordingly – there is no scope for the AER to place regulatory principles above the NGO.

However, in relation to the NGR, the AER must assume that the Rules have been developed to be in accord with the Objective, even if it considers that this is not the case[1]. Equally, the specific requirements in the NGL addressing network regulation (the six revenue and pricing principles in section 23) must be assumed by the AER to be consistent with the Objective.

Accordingly, the EUCV sees the ranking of the various elements of the NGL, NGR, AER discretion and AER pricing principles would be as follows:

1. NGO and NGL revenue and pricing principles
2. Specific requirements of the NGR
3. AER discretion
4. AER pricing principles

[1] The EUCV expects that if the AER considers the NGR not to comply with the Objective, then it would initiate a rule change to rectify this view

The importance of this ranking cannot be overstated. For example, the AER had in previous regulatory decisions accorded its regulatory principles above the NGO, and has done so again in this draft decision.

For example, the AER has the discretion to set a rate of return which is efficient recognizing that the NGR do not stipulate how the rate of return is to be developed. To achieve this, the AER has developed its own principles based on its views and to reflect the decisions of the Australian Competition Tribunal. The AER has then decided that its regulatory principles take precedence over the Objective, which requires that the rate of return be set at a level that is economically efficient[2].

Where the AER exercises its discretion, it must benchmark this exercise against outcomes seen in the "real world" of competitive business to ensure that its discretion results in an outcome which meets the requirements of the Objective.

To develop an approach to arrive at the allowed rate of return, the AER has developed principles for this development, but they must be in accordance with the Objective.

1.2 Regulation is intended to be incentive based

The Australian energy regulatory environment is intended to be incentive based. This means that regulated firms are rewarded for operating within a cost structure that is lower than the allowance provided by the regulator.

The corollary to providing this reward is that the benefits from the regulated firms finding lower cost ways of delivering the services, are passed on, over time, to consumers and the benefits effectively shared.

There are five basic elements of the building block approach to setting regulatory revenues for a service provider subject to price cap regulation that should be subjected to incentives, viz:

1. Deferring or minimizing capital
2. Developing more efficient opex
3. Reducing the cost of debt
4. Setting depreciation to be equitable to current and future users
5. Increasing flows to reduce the unit prices for reference tariffs

The regulatory decision should be crafted so that each of these five elements can be incentivised to provide lower overall unit costs to consumers over time.

[2] The EUCV concerns in this regard are developed in more detail in a later section of this submission addressing the cost of capital

It is also important to recognise that the intent of the Objective ("long term interests of consumers") is not to be interpreted so that the interests of existing consumers are to be excluded from assessment. As the Limited Merits Review Expert Panel comment in their stage 1 report to the Standing Committee on Energy and Resources (SCER)[3]:

> "It is the long-term interests of consumers that are relevant. This cannot reasonably be interpreted as meaning that the interests of consumers today are irrelevant, and that the only thing that matters is the welfare of energy consumers at some distant point in time. It does, however, mean that it is not just the interests of consumers who will vote in the next election that count: there are future generations also to be taken into account. To the extent that the AER is required to engage in 'balancing' judgments, the chief balancing required is between the interests of consumers at different points in time[4]." (page 37)

The import of the Expert Panel comment is that unless the interests of future consumers are impacted, then the AER must have regard for the interests of current consumers as a priority. If there is conflict between the interests of current consumers and of future consumers, then the interests of future consumers must be balanced against those of current consumers.

In addition, there is a need to recognise there is conflict between the impacts of the various incentives provided. Higher costs now might result in lower costs for future consumers but imposing higher costs now might have a negative impact on future consumers because of the changes made by current consumers to manage the higher costs

To put these observations into context for the current review, the EUCV considers that the AER is obliged to ensure that, in arriving at the efficient levels of allowed revenue, the allowed revenue must reflect the outcomes of the incentives provided in the previous regulatory decisions.

For example, GasNet is currently seeking to increase the depreciation rate for its assets and advises that this will reduce costs for future consumers. However, higher costs now could reduce gas consumption as consumers could convert to alternative fuels. Conversely, lower costs now will encourage gas usage so that costs in the future will be amortized over greater gas flows.

The power of incentives cannot be over-emphasized. Exogenous issues like the high $A, a price on carbon, compulsory renewable electricity generation and energy efficiency programs have all had the impact of

[3] Review of the Limited Merits Review Regime Stage 1 Report available at http://www.scer.gov.au/files/2012/06/Stage-One-Report-to-SCER-29-June2.pdf

[4] The Expert Panel goes on to highlight that the interests of consumers at different points of time is usually done through "some or other form of discounting".

leading to reductions in the use of gas and electricity and these have all impacted on the expected use of gas in the next five years.

The outcome of the regulatory incentives that the AER must impose is for the allowed revenue and reference tariffs required to reflect a need for the gas delivery service to be more efficient with lower unit costs, so that future consumers can have a gas transport service that meets their needs.

1.3 A view of the Victorian future gas demand

The AEMO has recently released its 2012 Gas Statement of Opportunities (GSoO). Its forecast in relation to Victorian gas consumption provides some salient points.

1. The 2011 Victorian gas consumption levels will not be exceeded until 2020
2. The 2008 Victorian gas consumption levels will not be exceeded until 2016
3. The Victorian gas mass market will remain at or below 2011 levels until 2016
4. Consumption by large Victorian gas users will not reach current levels until 2020
5. Consumption by gas fired generation will not reach 2008 levels until 2026

It is pleasing to note that the 2012 GSoO forecasts for gas consumption in Victoria closely correlate with the AER draft decision for gas consumption.

The observations drawn from the AEMO forecasts are critical to the current AER review, because the access arrangement was established on expectations and usage seen in 2007/2008. Bearing in mind that the current period (AA3) investment allowance provided considerable capex to address an expected growth in consumption that has proven to be optimistic, at the most basic level, over the next five year regulatory period, there will be:

- No need for any investment for augmentation as there are forecast reductions in gas consumption compared to actual consumption in AA3 and consumption is again at the levels seen during AA2
- A reduction in opex for any replacement investment made
- No need for any reliability investment as reliability is already at an acceptable level

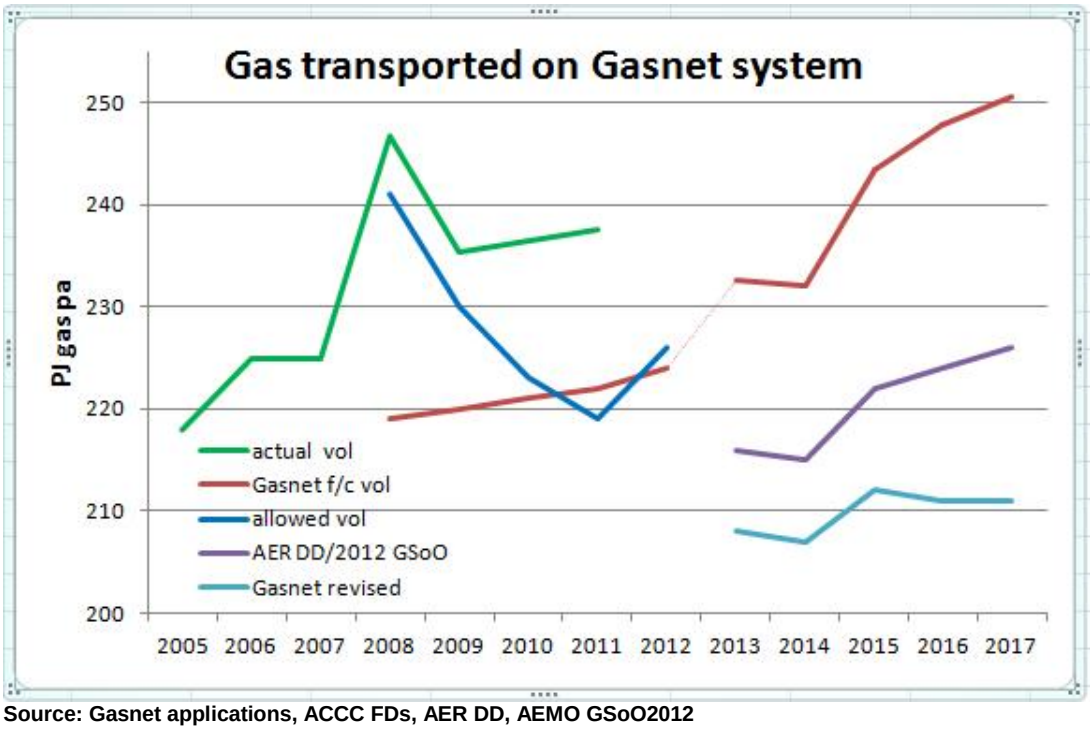
1.4 An overview of the draft decision

It is quite clear from the draft decision that the AER has identified a number of significant unnecessary costs that had been claimed by Gasnet. The AER has also identified that Gasnet has considerably overstated the expected

volumes of gas to be transported over the Gasnet system. The EUCV had provided a view Gasnet had overstated its forecast volumes and suggested that the AEMO 2011 GSoO should be used as the basis for forecast transport volumes. The AER considered that the 2011 GSoO overstated the expected gas volumes for gas powered generation and commissioned ACIL Tasman to provide a better estimate of gas volumes. Concurrently, AEMO carried out its 2012 GSoO and the forecasts closely correlate with the AER draft decision on expected gas volumes to be transported.

The assessment of forecast transportation volumes is critical on two bases – as an indicator of the need for augmentation capex and as the basis for developing reference tariffs; estimates of gas volumes that are too high support claims for increased capex but lead to lower notional tariffs, whereas, low forecast volumes indicate a need for less augmentation capex but result in higher tariffs. A gas network is incentivised to overstate volumes because this supports a high capex program and implies tariffs will be lower than they will be ultimately.

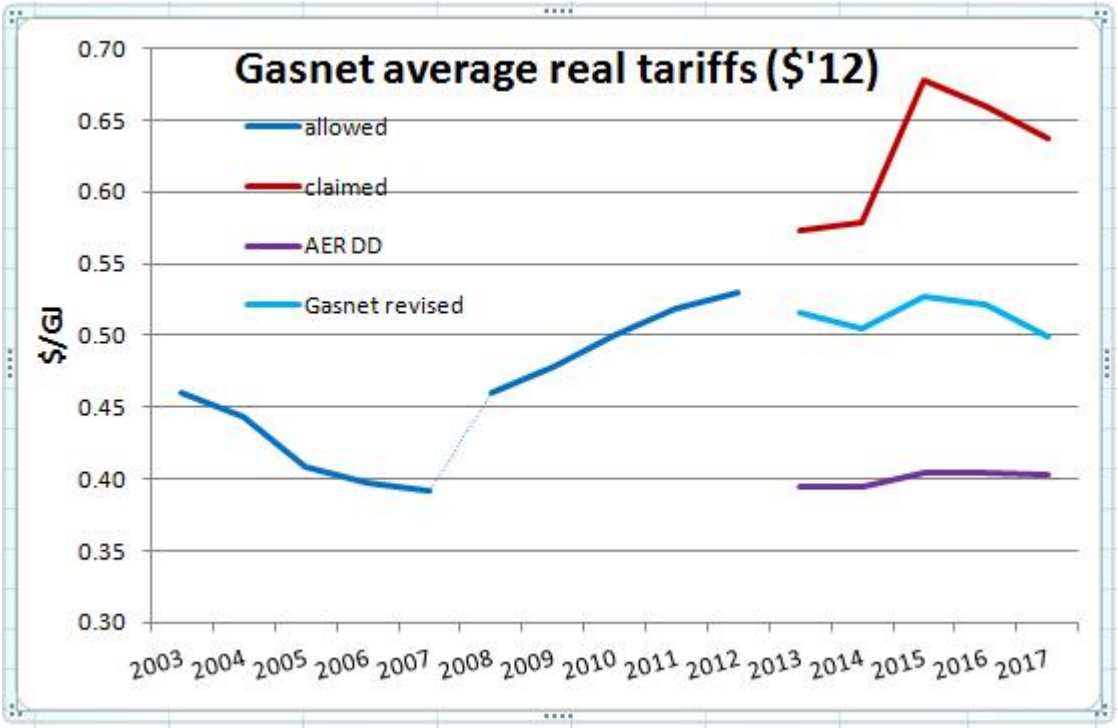
The following chart shows the historic actual and allowed gas volumes and the forecasts by Gasnet and the AER/AEMO.



Source: Gasnet applications, ACCC FDs, AER DD, AEMO GSoO2012

The risk to consumers of the low forecast of gas usage over the next five years will be similar to that in the current (AA3) period where gas volume forecasts have been low compared to actual volumes, and Gasnet acquired considerably more revenue than was expected to occur. That Gasnet achieved a considerably higher revenue than was forecast was a direct result of setting the forecast volumes too low.

With the revised assessment of expected forecast gas volumes, the EUCV has revised its indication of forecast and historic tariffs based on the AER/AEMO gas volumes and the AER draft decision for allowed revenue.



Source: Gasnet applications, ACCC FDs, AER DD, AEMO GSoO2012

This shows that the indicative tariffs provided by Gasnet in its application were significantly understated and without the AER reducing the allowed revenue, would have been misleading in the extreme. In real terms, the AER draft decision results in tariffs being much as they were at the end of the AA2 period before the massive hike in tariffs over the AA3 period

1.5 The EUCV'S General View of the Draft Decision

The EUCV notes that many of the concerns it raised in its initial response to the Gasnet application have been addressed in the AER draft decision. Despite the commentary provided by Gasnet in its revised application, the EUCV does not consider that there is a need for the AER to change many of the elements of its draft decision even though the revised application from Gasnet is seeking changes.

The main exception to the above comment is the continuing EUCV concern about the debt risk premium to be included in the WACC. This aspect is discussed in more detail in the following section on WACC.

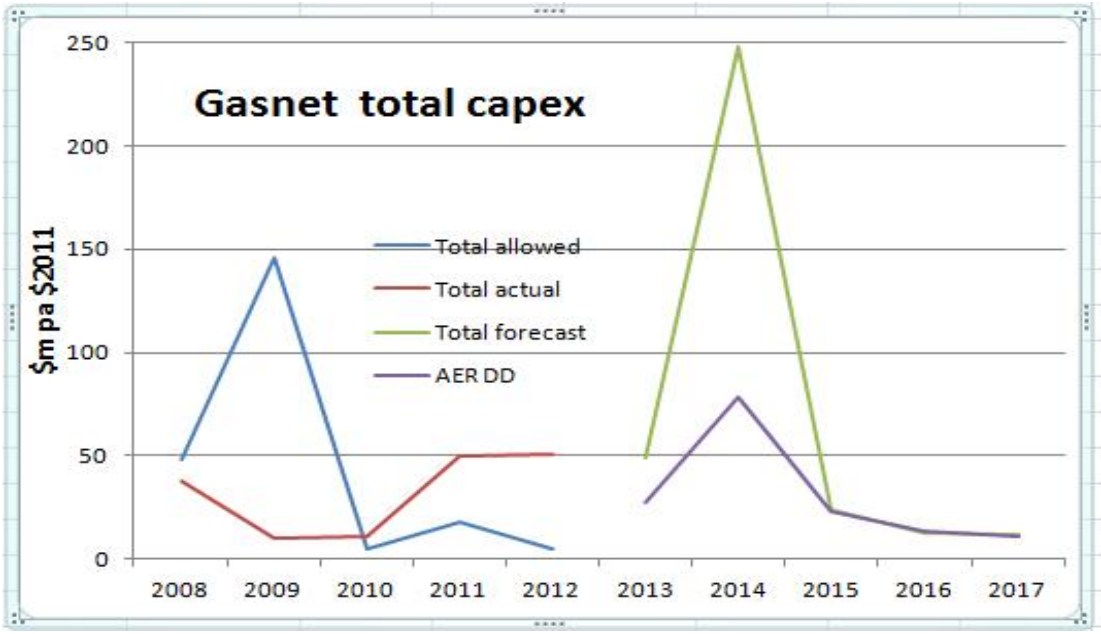
The EUCV also notes that much of the reduction in the average tariff is an outworking of the fall in the yield for 10 year CGSs. The AER needs to be

cognizant that the reduction is therefore short lived as, in time, the “risk free rate” will inevitably return to its long term level or even exceed this. It is therefore imperative that the AER ensure that the approach to determining other allowances is not relaxed and that all elements must be fully justified

2. Total Ex-Ante Capital Allowance

2.1 An overview of the Gasnet capex claim

The Gasnet forecast for total capex for AA4 and the AER draft decision allowances can be seen in comparison to the much lower actual capex for AA3 in the following chart.



Source: ACCC FD 2008, Gasnet application, AER DD

The AER draft decision capex allowance for AA4 is generally in keeping with the actual capex used by Gasnet in AA3.

The EUCV had identified in its initial response to the Gasnet application that a capex allowance for AA4 should be much the same as in AA3 based on the fact that conditions expected for AA4 are much the same as in AA3; such an allowance is sustainable on the basis of comparative benchmarking.

In its revised application, Gasnet accepts most of the AER arguments that much less capex is warranted, although Gasnet does still seek a higher capex allowance than the AER provides in its draft decision. This is an important concession with respect to reality regarding the Victorian gas market over the AA4 period.

2.2 The breakdown of the capex claim

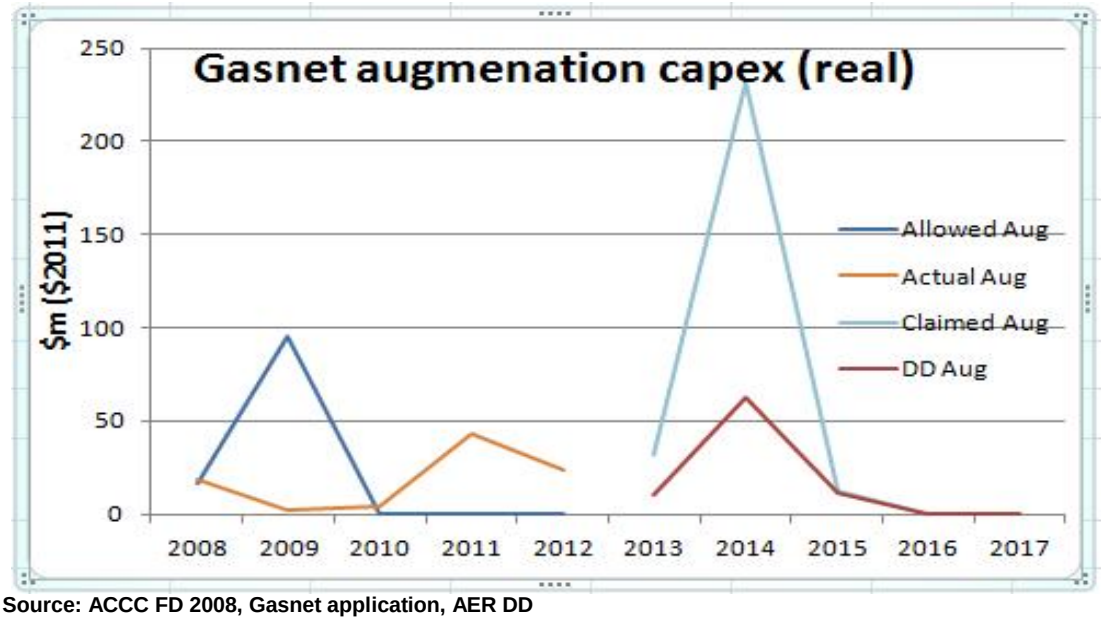
Gasnet advises that its capex is allocated to three main aspects – augmentation, refurbishment and upgrade and non-system capex. Allowed

and actual capex for AA3, forecast capex for AA4 and the AER draft decision for each element are detailed in the following sections.

Essentially, the AER has pared back the proposed augmentation capex considerably, but accepted the Gasnet claims for refurbishment and non-system capex

2.2.1 Augmentation capex

The following chart shows the Gasnet actual and forecast augmentation capex, along with the AER draft decision allowance.



Source: ACCC FD 2008, Gasnet application, AER DD

Augmentation capex for AA3 was actually more than 20% less than the allowed capex. The AER draft decision provides a similar amount of capex for AA4 as was actually used in AA3.

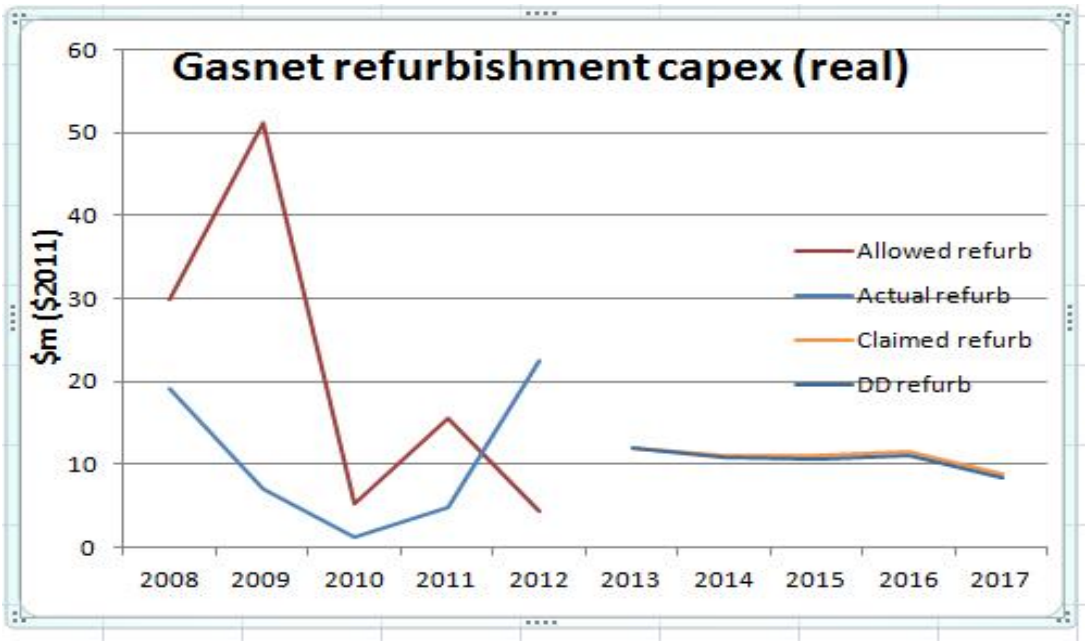
Generally, Gasnet has accepted the AER draft decision with respect to allowed augmentation capex for AA4 with some exceptions:

- Gasnet revised its assessment of the Culcairn augmentation to partially accept the AER draft decision to approve a project of lesser capacity. Gasnet has sought additional costs for the changed scope but does not prove that the additional cost claimed evidences a prudent project. Further, the EUCV is concerned that the risk of this enhanced cost will fall on Victorian consumers although the augmentation is designed to increase exports of gas. If the AER considers the increased cost is warranted then it must ensure that the risk of lower than expected exports is not transferred to Victorian consumers.

- In accepting the excising of the WORM project, Gasnet advised that it required some additional works at Brooklyn compressor station. The EUCV cannot comment on whether this additional work is required but expects the AER to verify that such additional work is prudent.

2.2.2 Refurbish and Upgrade capex

The following chart shows the Gasnet actual and forecast refurbishment capex, along with the AER draft decision allowance.

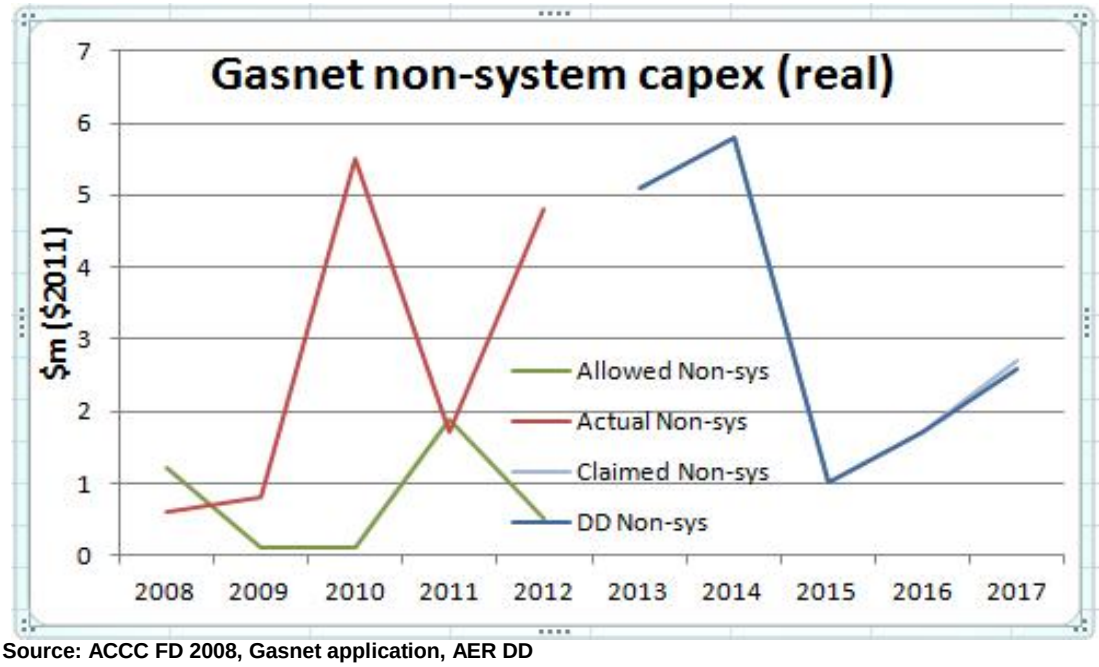


Source: ACCC FD 2008, Gasnet application, AER DD

After under-running considerably on refurbishment capex in AA3, Gasnet's application for refurbishment capex reflects an amount for AA4 which is similar to that actually used in AA3. The EUCV considered that the application for AA4 was a reasonable amount for refurbishment, and the AER draft decision reflects this apparent reasonableness in the claim by Gasnet.

2.2.3 Non-system capex

The following chart shows the Gasnet actual and forecast non-system capex, along with the AER draft decision allowance.



Source: ACCC FD 2008, Gasnet application, AER DD

In its response to the Gasnet application, the UECV considered that past non-system capex (AA3) was too high and not prudent, and that the forecast capex for AA4 included costs that were not prudent.

The AER has not accepted the EUCV concerns in its draft decision and considers that the actual non-system capex for AA3 was prudent and the amount forecast for AA4 is basically prudent. As the AA3 non-system capex over-run was a “once-off” cost and the high non-system capex for AA4 is basically driven by another “once-off” cost, the EUCV expects that, for AA5, non-system capex will revert to historic and lower levels

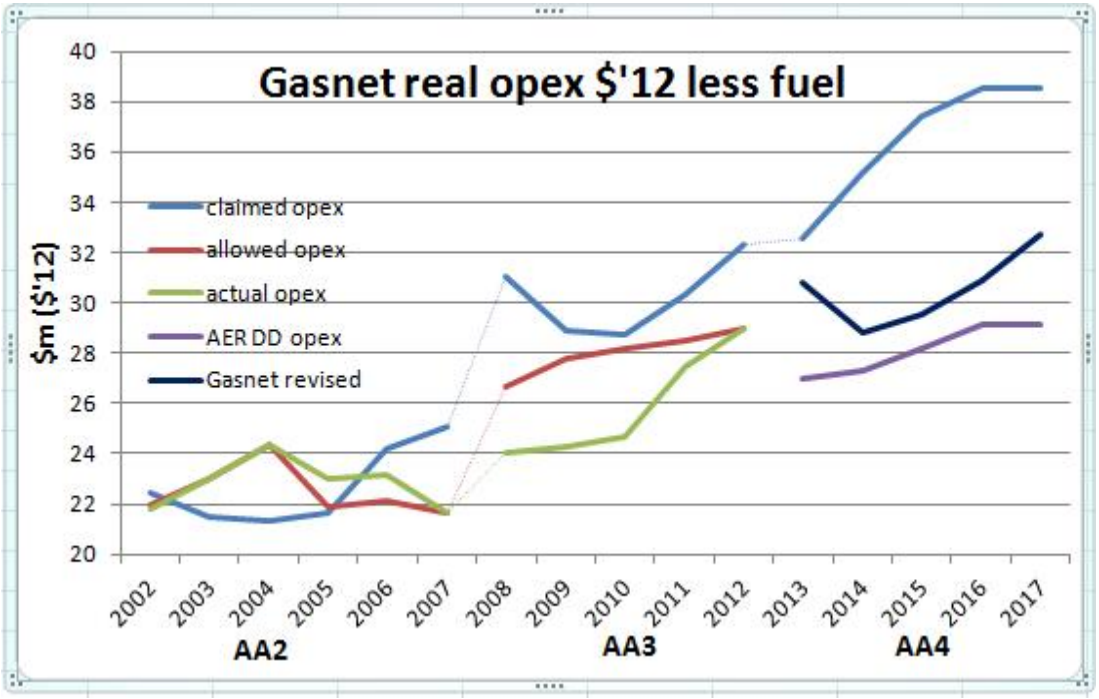
2.3 Summary of capex cost

Overall, the EUCV considers that the AER draft decision on capex allowances for AA4 represents a reasonable outcome for consumers.

The EUCV notes that Gasnet has sought to increase the capex allowances provided in the draft decision, but the EUCV does not consider that the arguments provided necessarily represent prudent investment. In particular, the EUCV is concerned that the augmentation proposed for gas transport to Culcairn is demonstrably prudent or that the risks inherent in gas flow forecasts for exports will not be transferred to Victorian consumers.

3. Forecast Operating Expenditure

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, AER DD

Overall, the EUCV considers that the AER has provided Gasnet with more opex allowance than is justified, especially in relation to the very high overhead allowances that appear to be embedded in the base year opex.

In its application, Gasnet sought an average of some $36.8m in annual opex. After seeing the AER draft decision which reduced the annual average opex by nearly 25%, Gasnet recast its opex in its revised application to be some 20% less than it originally sought.

This indicates that Gasnet is seeking ambit amounts for its opex and the EUCV still considers that its revised application includes considerable ambit claim when compared to its historic actual opex.

The EUCV considers that to a large degree, the requirement to use actual 2011 opex as the benchmark has allowed Gasnet to claim significantly more opex than it requires for efficiently operating the Gasnet system. The AER is urged to reassess its draft decision in this light.

3.1 Base year opex

In its response to the Gasnet application relating to opex, the EUCV pointed out that there appeared to be a number of anomalies with regard to actual opex. In particular, the EUCV highlighted the large step increase between the actual opex for the first three years of AA3 compared and the actual opex in the "benchmark year" of 2011 which Gasnet had determined (as a fixed principle) would provide the basis for the opex allowances into AA4.

The EUCV elicited evidence from Gasnet's application that the over $3m increase in opex costs between 2010 and 2011 was attributed to (by under $2m) direct opex costs and over $1m in overhead costs. This step increase of some 15-20% was not justified from actual changes in the environment that Gasnet operates in, and supports the view of the EUCV that that Gasnet had deliberately increased its benchmark year opex to provide a higher base for developing opex costs for AA4.

The AER draft decision significantly reduced the allowance for opex and the revised claim from Gasnet also shows a significant reduction from its application, although it does show an increase from the AER draft decision by some 10%.

The EUCV considers that predefining a specific year as providing an efficient level of opex is not an appropriate method for eliciting efficient opex levels – in fact, what it does is to incentivise a service provider to deliberately defer opex from earlier years into the benchmark year.

In its recent network rule change proposal, the AER has identified that predetermining the benchmark year for setting future opex might not provide the most efficient opex allowance for the future. Gasnet has included, as a fixed principle in AA4, that the opex for AA5 will be based on the actual opex incurred in 2016. This fixed principle is in contradiction to the flexibility sought by the AER in determining opex allowances in future regulatory decisions. The AER needs to ensure that building in such a fixed principle into the AA4 access arrangements does not prevent it from implementing the efficient opex level in future regulatory assessments under the new rules just promulgated.

The EUCV accepts that, because of the fixed principle, the AER is constrained from using a better method to identify the efficient opex level for use in setting the AA4 base opex. It is quite bizarre that Gasnet has been able to force the AER into using a benchmark level for future opex that is demonstrably not efficient. The AER must ensure that it is not so constrained in the future.

3.2 Adjustments to the base year opex

The EUCV has reviewed the draft decision adjustments to the operating costs and agrees with the changes the AER considers need to be made to the operating costs sought by Gasnet.

In its revised application Gasnet attempts to demonstrate that the AER is in error with regard to a number of the adjustments it made. The EUCV considers the Gasnet explanations are difficult to sustain when considered in the overall context that the 2011 base opex is over $3m more than the opex of the previous three years.

3.2.1 Cash vs accrual accounting

Gasnet opines that the AER has confused cash accounting with accrual accounting for various costs. The EUCV would find the Gasnet explanations more sustainable if the base year costs were similar (or even lower than) costs in previous years – yet they are not by a considerable margin.

Gasnet also confuses the various impacts on the base year with impacts on previous years. Cost accruals for unused leave apply to every year and so in previous years Gasnet would have accrued costs for unused leave, yet the costs of this are not observed as changes between previous years and the CPI adjustment would have accommodated such rises.

The argument that the defined benefit superannuation incurred costs above the CPI adjustment are not supported when the opex costs between 2008 and 2009 show little change yet in this year the cost accruals for a defined benefit scheme would have been massive as the ASX accumulation index fell by 25% between June 2008 and June 2009. In contrast, the opex between 2010 and 2011 rose by nearly 20% yet the ASX accumulation index increased by 11% between June 2010 and June 2011 implying a lesser opex would have resulted.

3.2.2 Step changes

Gasnet confuses the concept of step changes. A step change is an outcome of an exogenous change imposed on a service provider. It is not a change that a service provider considers is “a good thing” to do that it hasn’t done before or may decide to do differently.

When examined in this light the AER decisions as to step changes is consistent and logical.

In its revised application, Gasnet refers to a new Australian electrical standard for hazardous areas and argues that this imposes increased obligations that have not previously applied. What Gasnet does not do is to show that the new standard imposes increased activity above that required previously or what Gasnet had previously done. The fact that a new

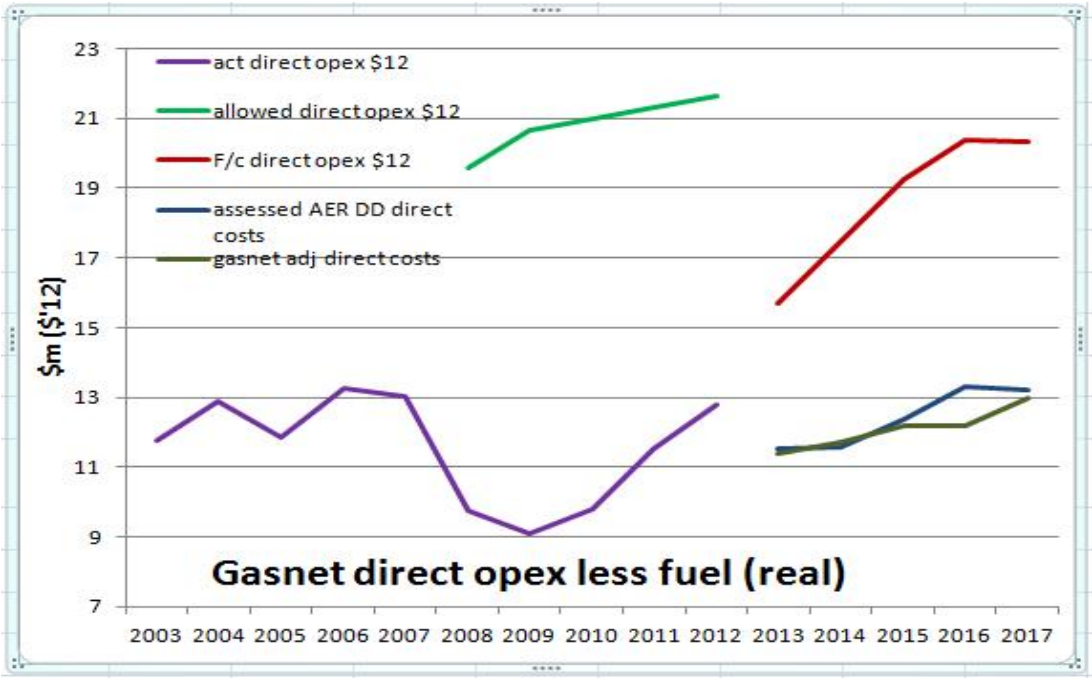
standard defines what is to be carried out does not in itself mean that the requirements have increased – it only details how the activity must be recorded. EUCV members have been responsible for many years to ensure that inspections of hazardous areas are carried out. To justify the increased costs, Gasnet should detail how the previous standard or Gasnet practice has been changed to meet the requirements of the new standard and then prove how the costs have increased and that they can be directly attributed to Gasnet.

3.3 Direct opex

The bulk of the adjustments the AER draft decision makes to the allowed opex are related to direct opex and the outcome of this seems to support that the direct opex for AA4 is consistent with historic direct opex. As in the response to the application, the EUCV has normalized the direct costs to exclude fuel costs.

Unfortunately, the AER draft decision does not provide a listing of its adjustments under the basic headings of direct costs and overhead cost used by Gasnet. To overcome this, the EUCV has assumed that 75% of the deduction made by the AER to the Gasnet application is attributable to direct costs and the balance to overhead and other costs

The following chart plots Gasnet direct costs over time on a consistent basis



Source: ACCC FD 2008, Gasnet applications and rev applic, AER DD, EUCV assumption

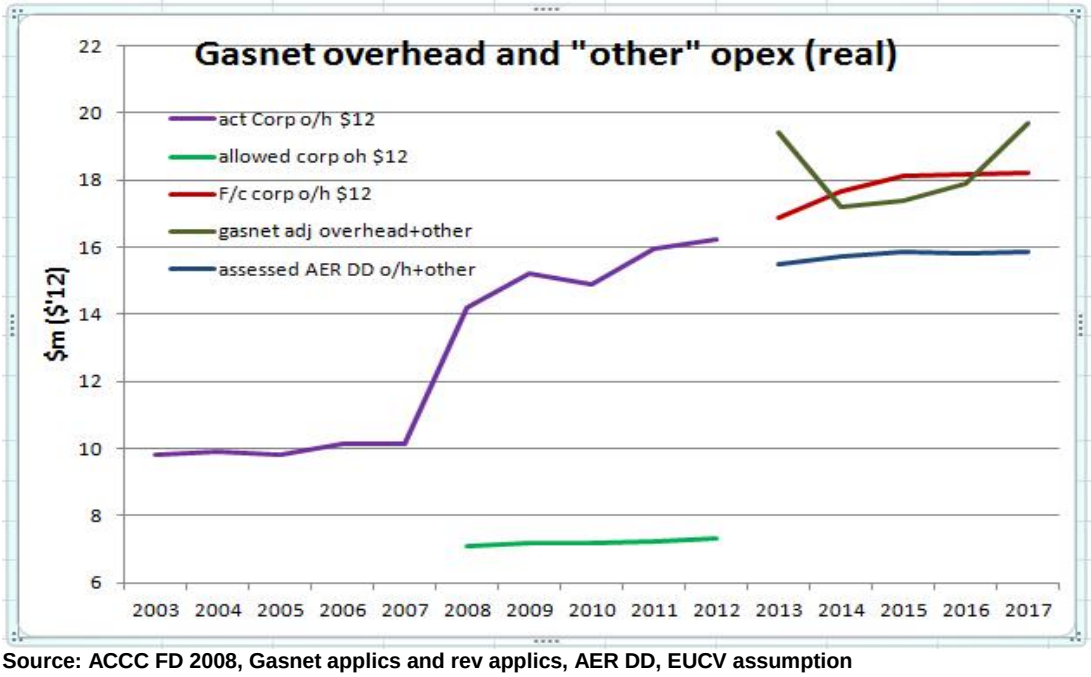
There is a reasonably close correlation to the assessed AER direct costs, the revised application direct costs and the benchmark 2011 direct costs. And the slight increase in direct opex overtime would be consistent with the small increase in the Gasnet assets allowed for in AA4.

On this basis the revised application for direct costs would seem to be reasonable.

3.4 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 3.3 above, comprise in total all of the elements of Gasnet opex less fuel.



Source: ACCC FD 2008, Gasnet applics and rev applics, AER DD, EUCV assumption

This chart reveals some interesting facets.

- There is a 50% step increase in overhead and other between AA2 and AA3 which is not replicated in the direct costs. The EUCV assumes that this is a result of the acquisition of Gasnet by APA, with APA adding to the overhead costs of Gasnet without increasing the overall efficiency of the firm. The acquisition of Gasnet by APA

was intended to bring cost reductions but has actually resulted in higher costs for consumers, with no added benefit

- The AER adjustment makes the overhead and "other" consistent with the benchmark performance of 2011. This would be expected as there would not be a need to increase overhead costs significantly as a result of the changes made during AA3. In contrast, Gasnet is seeking a significant increase in the benchmark overhead and "other" costs
- The reduction in the Gasnet revised application for overhead and "other" seen in the middle three years (2014-2016) relate to a negative carry forward of the EBSS. When this effect is excluded the average overhead and other cost averages nearly $20m pa in real terms. This is a 25% step increase in the basic overhead and "other" cost above the benchmark 2011 cost, but the reasons for this are not provided.

Overall, Gasnet has already inflated overhead and "other" cost for AA3 of some 50% compared to the actual costs incurred in AA2. This is now compounded by another 25% increase for AA4. The EUCV is at a loss to understand how Gasnet's overhead costs have effectively doubled in just the five years between AA2 and AA4. The AER must investigate this issue further and make the necessary adjustment in the allowances determined.

3.4 Summary of opex cost

Gasnet sought a step increase in opex from the current average allowed opex of 30% and an increase of 40% above the actual average opex. The AER draft decision limits this increase a little and holds it near the actual opex incurred in 2011. The revised application seeks an increase above the 2011 benchmark year by over 10%. This is a significant reduction from the initial application but the EUCV considers there is still a fair degree of ambit within the revised claim.

Analysis of the causes for the variance between the AER draft decision and the revised application shows that they are entirely within overhead and "other" costs and not with direct opex costs. The EUCV does not accept that the Gasnet overhead and "other" costs should increase at all from the 2011 benchmark costs, especially when it is seen that the 2011 benchmark costs are a massive 50% increase from those costs actually incurred in AA2, implying that the AA3 actual costs are not efficient. The AA4 claims are even less efficient.

In its initial response to the application, the EUCV commented:

> "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."

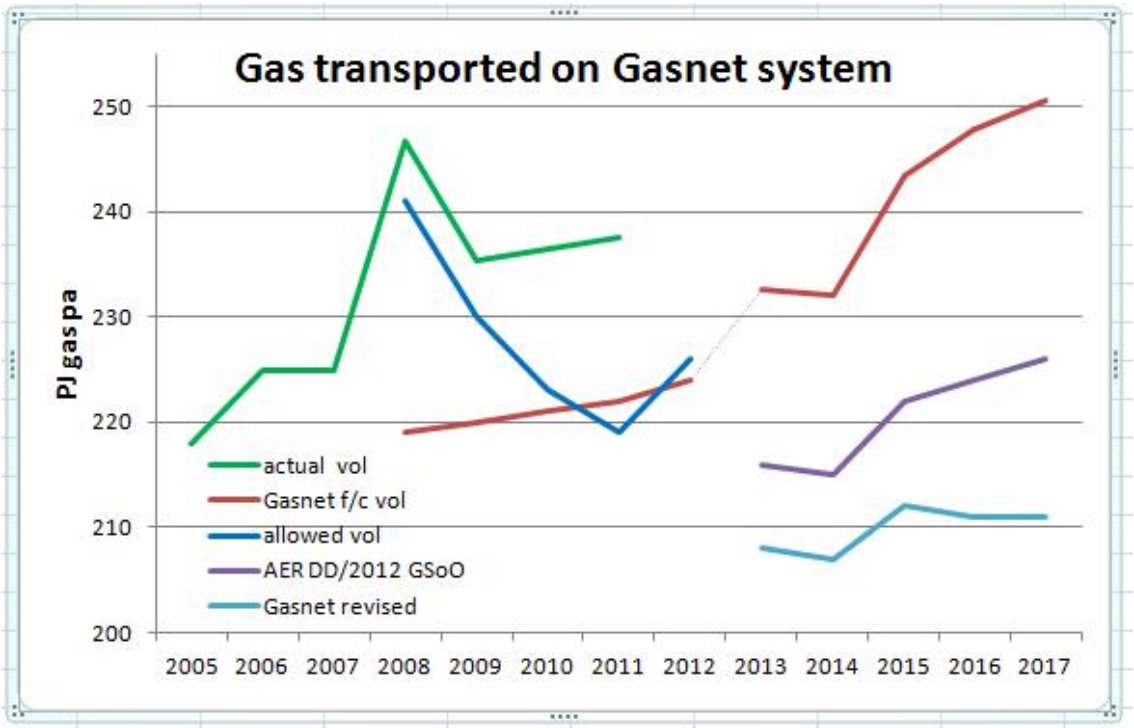
Unfortunately, little notice has appeared to be given to this observation by the AER. This must be rectified as the extent of the ambit claims is so obvious.

4. Forecasts gas demand and consumption and escalation

4.1 Gas demand and consumption forecasts

The EUCV notes that the AER considered that the Gasnet gas demand and consumption forecasts were too high and the AEMO 2011 forecasts might also be too high. As a result, the AER commissioned ACIL Tasman to prepare a forecast to be used as the basis of the AER draft decision.

Since then AEMO has released its 2012 Gas Statement of Opportunities (GSoO). The latest AEMO forecast exhibits close correlation with the ACIL Tasman forecasts. The EUCV considers that the AER should use the latest forecasts and notes that in its revised application Gasnet appears to consider that less gas will be transported than is forecast by ACIL Tasman and the AEMO 2012 Gas SoO. This is shown in the following chart.



Source: ACCC FD, AER DD, Gasnet applics and revised applics, AEMO 2012 GSoO

The EUCV finds it intriguing that Gasnet has revised its forecast volumes of gas to be transported by reducing them by 10% or so in such a short time, especially as, at the same time, Gasnet is of the view that gas flows to Culcairn will be higher than assessed by the AER.

The EUCV has no better information on which the AER might assess the difference in view regarding Culcairn flows and suggests that it get independent advice from AEMO on this issue. As noted in section 2 above, the EUCV is concerned that if the AER accepts the forecasts from Gasnet for Culcairn gas flows and allows the capex for the increase in capacity, then

the final decision must ensure that Victorian consumers are not exposed to any under-run on gas flows through Culcairn

4.2 Escalation forecasts

Gasnet has provided a view that its forecasts for capex and opex are based on costs applying at 2012 and that adjustments are required to reflect actual costs in the future as the costs are expected to exceed CPI which is included in the basis for future tariffs The AER has concurred with this view and has provided its views on expected cost changes to be included in the forecast costs.

4.2.1 Movement in the price of materials

Gasnet had not sought an adjustment to reflect the expected changes in the costs of materials. The AER also has not included any adjustment for materials price changes either. As EUCV commented in its initial response to the Gasnet application, the import of this decision is that materials costs are expected to increase at less than CPI and therefore Gasnet would be incur lower costs adjustments if materials prices were included in the adjustment process.

The EUCV noted that this results in consumers not getting the benefit of lower materials pricing yet when these rise faster than CPI, the AER allows these to be used to adjust future prices. This is inequitable and the AER needs to address this issue as part of its new guidelines for network regulation. There is nothing in the Objective that explicitly states that consumers should bear such risks and not receive benefits when circumstances are reversed.

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 and incorporated adjustments for future productivity increases.

4.2.2.1 Productivity adjustments
Gasnet commented that, although it did 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 disagreed with Gasnet's reasoning on this issue but agreed that labour costs should be adjusted for productivity.

The AER has disagreed with Gasnet with regard to the use of labour price movements (the AER sees that labour price indices – LPI – are more

reflective of future labour costs than the AWOTE preferred by Gasnet) and has decided to change its practice used in previous regulatory decisions and decided not to adjust indices for future productivity.

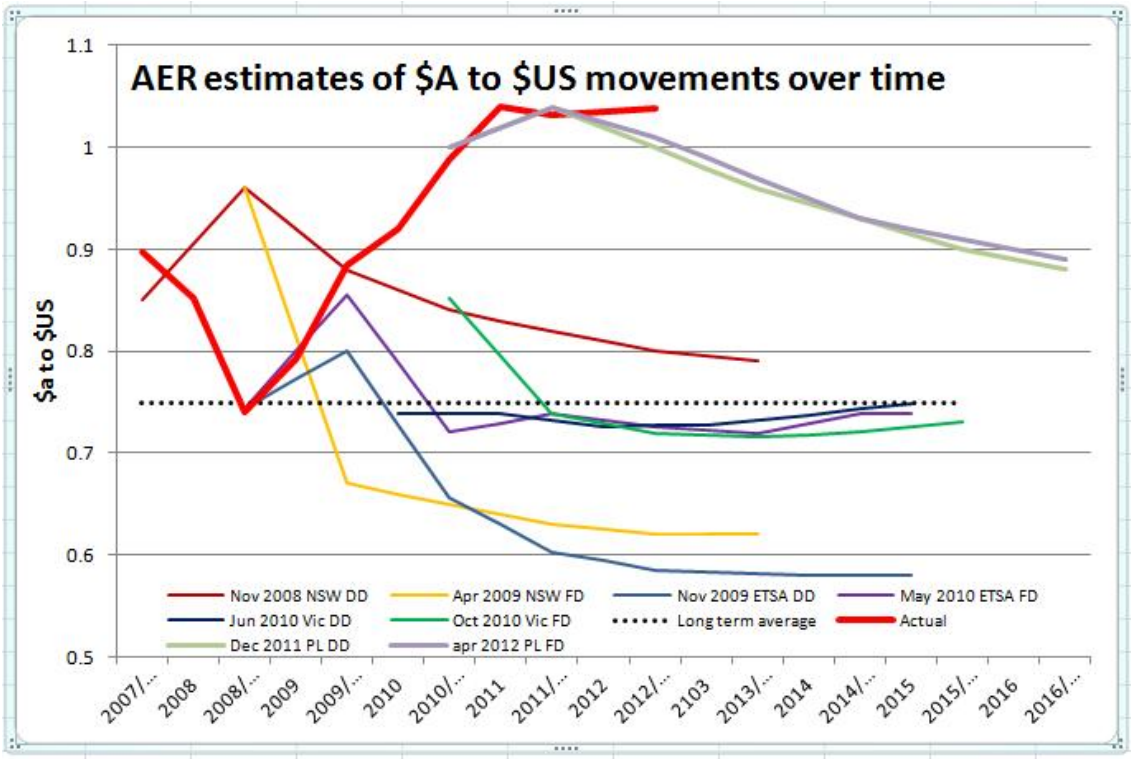
The EUCV sees that the AER decision to continue the use of LPI is consistent with its reasoning used for many years for quite valid reasons and that it has consistently supported through well developed arguments.

What bemuses the EUCV is the change to excluding productivity adjustments for this decision – especially for the reasons given; that the development of productivity adjustments is difficult even though the AER openly comments:

> "The AER considers that in theory productivity adjustments should be applied to real cost escalations if productivity adjustments are not undertaken elsewhere in opex and capex forecasts.
>
> However, the AER notes the high degree of difficulty in estimating both quality adjusted labour productivity and conventional labour productivity as evidenced by the conflicting productivity estimates from BIS Shrapnel and DAE and the analysis conducted by the PC.
>
> Thus, while the AER expects worker productivity to improve over the long run, due to estimation difficulties, it has not sought to address this effect, at this stage, in APA Gasnet's forecasts of labour costs." (DD pages 73 and 74)

That the AER is prepared to allow Gasnet increased costs above the efficient level due to difficulties in estimation is beyond belief, especially as the AER has previously allowed other increases in costs when estimation has been "difficult" (such as changes in the exchange rate, which are even more difficult to forecast!).

Thus, the AER has consistently allowed increases in future costs of imported materials used by regulated service providers based on low estimates of the $A. The past performance of the AER in assessing exchange rates has been quite poor (almost entirely in favour of the regulated firms) as the following chart shows.



Source: RBA, AER decisions

The AER admits that it should apply productivity adjusted labour cost movements but declines to adjust for productivity because of the "estimation difficulty" while it willingly expresses its competence to adjust for exchange rates – albeit with extremely poor results (and not without severe warning and criticisms from EUCV and other consumer groups)..

To forecast a productivity adjusted future real labour cost requires the forecaster to estimate future labour costs, future inflation and future productivity. Excluding one element of an adjustment because of difficulties in estimation implies that forecasting future labour costs and future inflation are more accurate than future productivity. Such a view smacks of hubris, especially when compared to other forecasts the AER has made in recent years.

The AER is required to provide regulatory certainty in its role. By changing its approach just for Gasnet and the other Victorian gas transport firms yet applying it to others introduces regulatory inconsistency. When such an inconsistency is purely based on a recently discovered "difficulty" with estimation provides no reasonable basis for changing regulatory practice.

4.2.2.2 Accuracy of labour forecasts

As part of the analysis for the decision to use LPI in lieu of AWOTE, the AER provided a table of the past performance of Access Economic (DAE) and BIS Shrapnel (BIS) in forecasting actual labour movements (see for example table C2 in section 3 of the draft decision on Multinet).

This data is quite fascinating and from it the AER concludes that the LPI forecasting by DAE is more stable and exhibits less volatility than dies BIS forecasting and so the AER considers the DAE forecasting is preferred.

What the AER does not do is to assess the actual accuracy of the forecasts over time. For example, the DAE forecast for EGW made in 2007 for year 2010/11 shows a small under-run compared to the actual LPI. Yet these forecasts are compounded – the forecast for 2010/11 is the compounded increase of all the previous years of data.. When compounding is implemented, the actual increase in LPI for 2010/11 based on movements from 2007 implies labour costs in 2010/11 were 24% higher than in 2007. The DAE forecast for the same period shows an increase of 26% (the BIS increase is nearly 29%).

Further, the errors between the actual values and the forecasts show a consistent overestimation of future LPI values. The number of times the forecasters underestimated the actual LPI is 25% whereas the overestimates comprise 60% of the forecasts – the balancing 15% is where the forecasts were accurate. On this basis the forecasters are likely to overestimate the LPI 4 times more than they get it right and underestimate it 2 times more than they get it right.

These actual calculations and comparisons show that the forecasts are biased towards overestimation and so impose increased and unnecessary costs on consumers.

4.2.2.3 Summary
While the EUCV agrees with the AER that it is more appropriate to use the less volatile LPI forecaster, it does not agree that including the productivity adjustment should be excluded on the basis that there is inherent inaccuracy.

As there is an inherent bias of overestimation of future LPI estimates, including the productivity adjustment will tend to reduce the overt bias that the actual LPI forecasts already include.

4.2.3 The Gasnet approach

In its revised application, Gasnet proposes:

- Internal staff wage cost adjustment should be based on its Enterprise agreement (EBA)
- External staff wage cost adjustment should be based on the average of the AWOTE and LPI forecasts

The EUCV does not agree that the EBA should be used as the basis for wage adjustments. An EBA is a unique arrangement made between an employer and its staff and reflects many different needs. The allowed costs for providing network services is based on the notional efficient provider and not on the future movements in wage costs agreed by a specific firm. The risk to consumers if the AER allows an EBA to be used as the basis for future wage movements would allow a specific firm to agree on wage growths above what an efficient firm would allow, in the full knowledge that the regulator will include such increases without demur. This is unacceptable to consumers. Such automatic cost escalation goes against the grain of incentive regulation, more so when it the issue concerns wage growth and productivity growth where firms involve in EBA mandate tradeoffs between the two factors.

The EUCV does not agree that averaging of two indices which are derived from two different approaches is an appropriate method for setting an expectation of future wage movements. To do so would introduce regulatory inconsistency. The AER has endeavored to introduce similar approaches in the past (eg using an index for debt risk premiums in conjunction with a debt risk premium seen in the “real world”) and such has been rejected as an appropriate methodology. To do so with this regulatory decision would again smack of regulation practices being made “on the run”. If the AER sees merit is such an approach then it should introduce such a change with proper debate such as during the development of the new regulatory guidelines currently being assessed.

5. Cost of capital, depreciation and allowed revenue

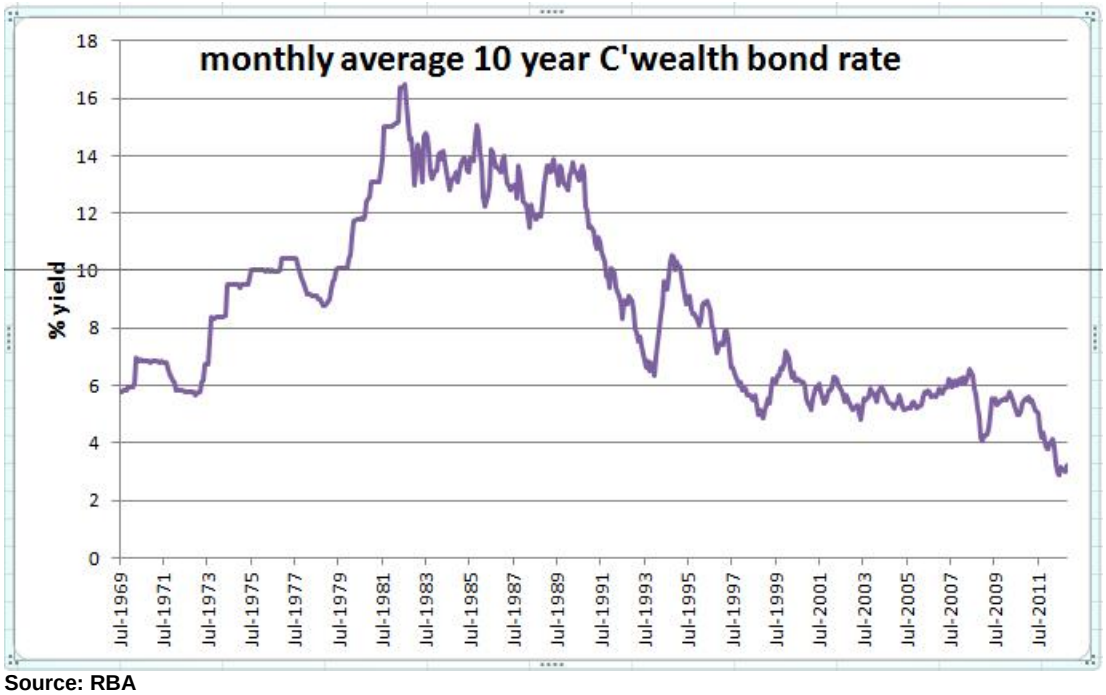
5.1 Weighted average cost of capital (WACC)

In its draft decision, the AER used the same approach to setting the allowed WACC as has been consistently used by Australian regulators for the past 15 years. The various WACC parameters used by the AER are essentially the same as used in previous gas pipeline decisions, but with minor changes.

Despite this, Gasnet has highlighted in its revised application that the process used is no longer valid. To back up its case, Gasnet has provided a number of views from learned economists that the basic approach used by the AER is now demonstrably flawed. The entire argument posited by these experts is that using the 10 year Commonwealth bond rate as the risk free rate and adding to it the long term market risk premium (MRP) and the assessed debt risk premium (DRP), is no longer valid. They posit that with a low risk free rate, higher values of MRP and DRP are needed. The cause of this change is that the 10 year bond rate is now at the lowest value recorded in the past 40 years. The long term average of the 10 year bond rate is 8.7% and the average of the past 12 years is about 5.4%.

It must also be noted that the bond rate has reached a monthly average low of 2.89% and the monthly average for December 2012 it is 3.22%.

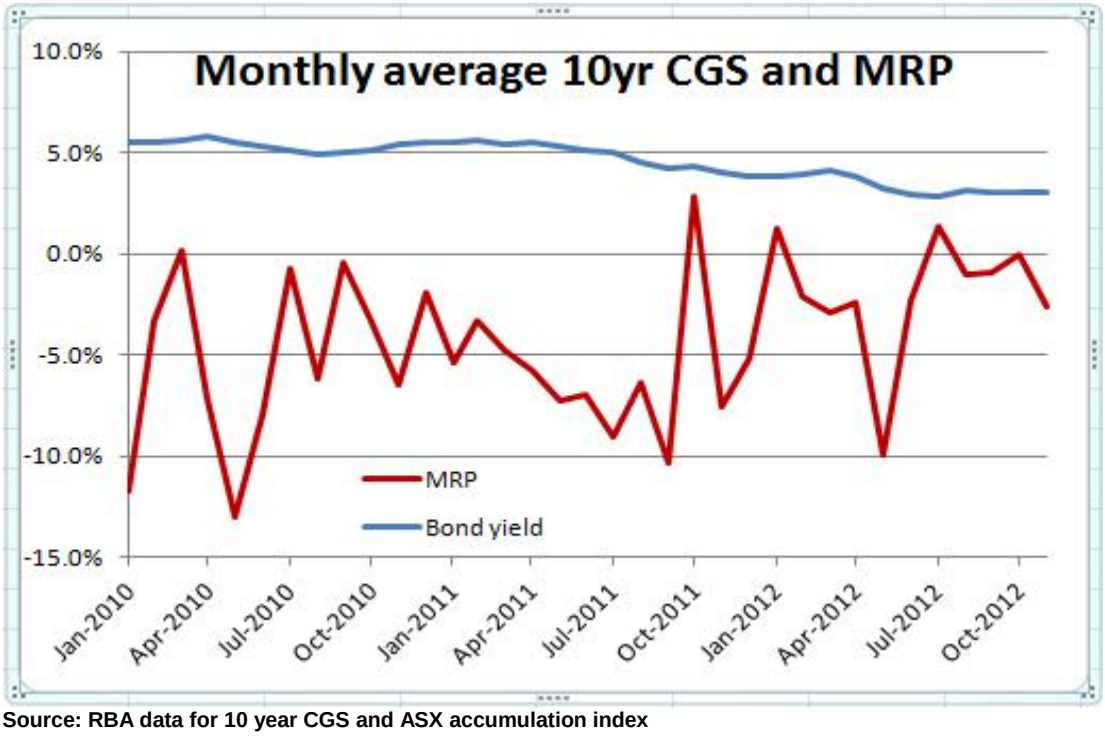
Below is the average monthly yield on 10 year Commonwealth bonds since 1969



Source: RBA

The Gasnet experts posit that the return on equity is a notional constant over time regardless of the movement of government bonds. They posit that applying the long term market risk premium to the government bond rate does not reflect this "truism". It is clear that since the advent of incentive regulation in the late 1990s the 10 year bond rate has averaged 5.4% and when the long term market risk premium of 6% was added to the average bond rate of 6%, the return on equity was seen to be about 11.4% based on an equity beta of 1.0. Because of this they consider the AER has to change the way it (and other Australian regulators) have consistently calculated WACC.

There is little doubt that the fundamental reason for Gasnet seeking a higher MRP is because the risk free rate is currently so low. If Gasnet and its experts are correct that the low risk free rate is associated with a higher MRP then this would be apparent since the low bond rate appeared in the last 12 months or so. In fact, the reverse is the case. The current lower than average bond rate has been associated with MRP values that are mainly negative and barely become positive. This is shown in the following chart.



Source: RBA data for 10 year CGS and ASX accumulation index

As can be seen, the bond rate has been at its 12 year average for over half of the last three years and this has been associated with negative MRP values even though during this time the AER granted an MRP value at the long term average of 6%. The lower bond rate seen over the last 15-18 months or so has been equally associated with an MRP of zero or for all but 3 months of the last 18. For Gasnet and its experts to claim that the lower

bond rate needs a higher MRP than the long term average is just not supported by the facts and recent actual outcomes!

It must also be stated that for much of 2012, there has been considerable debate as to the best way to set the WACC for regulated firms (as a direct result of the AER proposed rule changes for network regulation) yet throughout the many debates and forums discussing the development of the WACC, the only two issues that arose regarding the setting of the risk free rate were:

- The averaging period of the risk free rate to set the forward looking risk free rate for the regulatory period, and
- Whether the risk free rate should be set to align with the regulatory period applying to the determination – whether the 5 year bond rate should be used for a 5 year regulatory period and a 10 year bond rate for a 10 year regulatory period

There was no discussion that using the 10 year CGS as the risk free rate was inappropriate for use in setting the WACC.

The EUCV can understand that with the current low risk free rate, this does reduce the WACC calculated for regulated firms and that they would seek to find ways of increasing this. This approach by the regulated firms that a higher MRP is warranted because the spot MRP compared to the spot risk free rate is higher than the long term MRP used by regulators is not supported by the facts.

The EUCV makes the rhetorical observation whether the massive debate as to the setting of the risk free rate would have been raised if the bond rates were at the levels seen in the 1980s, with an average value of some 13%, rather than the current value of about 3%? Would there be a debate that the return on equity has a constant value of about 12% when the AER approach would deliver a value of 19%?

This call for an increase in MRP must be seen in the context of recent (and unsuccessful calls by consumers) for a change in the way debt risk premiums are calculated.

As the bond rate has fallen in recent times (since the Global Financial Crisis) the debt risk premium as forecast by CBA Spectrum and Bloomberg has risen well above actual the cost of debt. Despite this, the regulated firms have consistently argued that the AER has to comply with the Statement of Regulatory Principles (SRP) established by the ACCC and AER must prevail – that spurious outcomes from the application of the SRP must be applied regardless of whether the outcomes deliver a patently high cost of debt. The EUCV has noted that in recent AER decisions, the cost of debt has nearly reached the cost of equity, despite the fact that the cost of debt has always

been considerably lower than the cost of equity due to the much lower risk profile.

The EUCV affiliate NTMEU made the point in the AER decision on the Amadeus gas pipeline (AGP) that it was granting a debt cost allowance some 200 bp higher than the cost of debt that APA (AGP owner) had actually acquired debt for on the open market, and that the actual cost of debt to APA was even lower. The reason that APA (and the AER) gave for using this blatantly excessive debt cost allowance was that there needed to be regulatory certainty. The Australian Competition Tribunal also considered that the approach detailed in the SRP had precedence over actually observed outcomes that would have been more in the "long term interests of consumers" as required by the Objective.

Just as the EUCV affiliates identified that the SRP had imposed much higher costs on consumers than was warranted through the rigorous application of the SRP in setting the WACC when there were anomalies in calculating debt risk premiums, so too the regulated firms must accept that sometimes, the application of the SRP will be to their disadvantage. If regulatory certainty is sufficient justification for consumers to pay more than is necessary for regulated services, then so it is just as appropriate for network services providers to be granted a lower WACC than they would like.

The AER has advised that it will develop new guidelines for developing the WACC to apply to regulated energy assets and this is the time to address changes to the way the WACC is developed – not to make major changes on a case by case basis as part of a specific regulatory review.

Just as the AER has refused to accept changes to the setting of the DRP, so must it refuse to make a change to setting the MRP until the entire approach to setting regulatory rates of return has undergone the formal processes already in train.

5.2 Depreciation

Gasnet has proposed a change to the way its assets are to be depreciated from the approach it used for the past three regulatory periods. The EUCV sees that despite the Gasnet desire to change the approach to setting allowed depreciation, the AER considers that the historic approach to depreciation should continue unchanged.

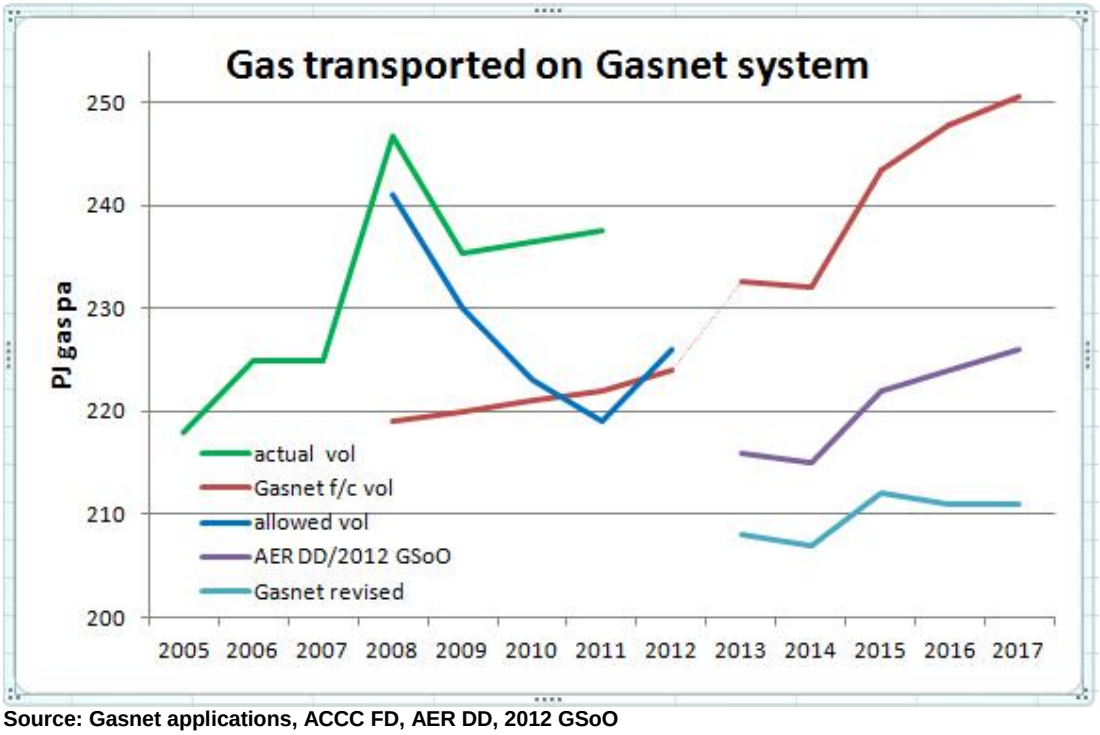
The proposal by Gasnet to increase the depreciation allowance clearly has its genesis in the reduction in revenue that Gasnet sees will result in the next regulatory period (AA4) due to the lower WACC that will apply due to the low risk free rate. This assessment is supported by the report to Gasnet from PwC (Mr Jeff Balchin) provided with the revised application, which points out that higher tariffs should apply when an assets is heavily used in

order to incentivise change in usage patterns. PwC considers that setting higher tariffs will promote efficient growth in the market and will maintain consistency in tariffs rather than the sharp downward adjustment followed by constant prices that the AER approach would provide.

As depreciation of an asset is permitted only once, the increasing in depreciation allowance (however done) has the effect of transferring depreciation that would occur at some time in the future, to the present, with current consumers paying a premium for the benefit of future consumers.

What Gasnet and PwC do not consider in their analyses and arguments is that the forecasts for gas consumption over AA4 are that there will be a significant reduction in AA4 compared to AA3. This reduction has been identified by ACIL Tasman for the AER and in the AEMO 2012 GSoO which both show a close correlation in forecasts. Gasnet revised forecasts are 5% lower than those forecast by AER/AEMO reinforcing the view that lower consumption will occur.

The actual and various forecasts of gas consumption provided are shown in the following chart.



Source: Gasnet applications, ACCC FD, AER DD, 2012 GSoO

What the chart highlights is that utilization of the Gasnet assets is likely to fall by 10-15% for AA4 compared to 2011. Therefore the commentary that higher tariffs are justified because they reflect high utilization and a drive to better utilize assets, is not sustainable. In fact, lower tariffs are preferable in the case of falling utilization as this provides an incentive to increase usage.

A reduction in demand places higher costs with consumers as the allowed revenue is recovered over a lesser amount of gas. If there is a clear fall demand, to argue that higher tariffs are required because this is more efficient becomes a spurious argument. In fact, because there is falling demand, lower tariffs are more appropriate to encourage greater use of the assets.

The EUCV notes that there are five criteria on clause 89 of the Gas Rules that apply to the depreciation allowance in the reference tariffs. These are:

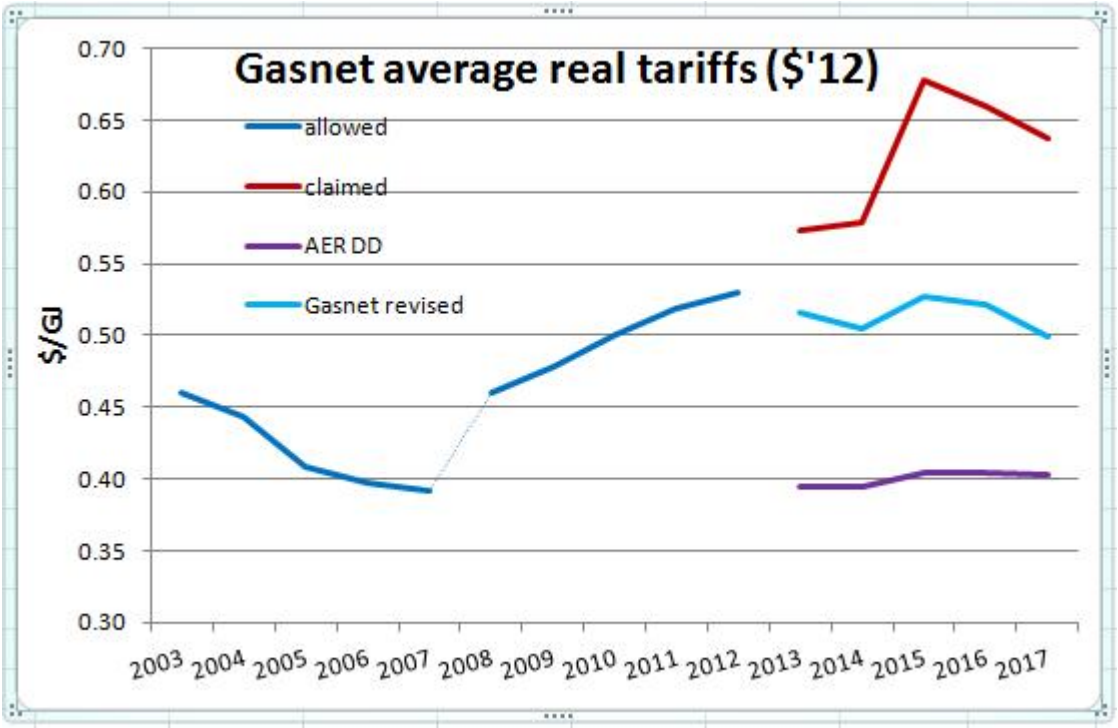
> The depreciation schedule should be designed:
> (a) so that reference tariffs will vary, over time, in a way that promotes efficient growth in the market for reference services; and
> (b) so that each asset or group of assets is depreciated over the economic life of that asset or group of assets; and
> (c) so as to allow, as far as reasonably practicable, for adjustment reflecting changes in the expected economic life of a particular asset, or a particular group of assets; and
> (d) so that (subject to the rules about capital redundancy), an asset is depreciated only once (ie that the amount by which the asset is depreciated over its economic life does not exceed the value of the asset at the time of its inclusion in the capital base (adjusted, if the accounting method approved by the AER permits, for inflation)); and
> (e) so as to allow for the service provider's reasonable needs for cash flow to meet financing, non-capital and other costs.

There is no disagreement between the AER and Gasnet's commentary regarding criteria (b), (c) and (d), and the EUCV agrees that the proposal complies with these criteria. The arguments Gasnet provide for its disagreement with the AER approach lie with criteria (a) and (e).

With regard to criterion (a) Gasnet provides a view that higher tariffs now with lower tariffs in the future will provide the basis for efficient utilization of the assets. As noted above, what Gasnet fails to recognise and address, is that it is forecasting a considerable reduction in gas transport.
In this regard, the EUCV notes the clause 89(2) – an argument that Gasnet has used to justify higher tariffs – specifically highlights that depreciation can be deferred when setting higher tariffs (as might occur when a new pipeline commences operation) might not encourage greater utilization.

Gasnet comments that maintaining the tariffs at near current levels is more efficient than the AER approach which results in a step reduction in tariffs. What Gasnet does not take into account is the falling demand for gas transport in AA4 compared to AA3.

The EUCV is of the view that the falling demand warrants the maintenance of the historic approach used by Gasnet to providing for depreciation. However a view of the current price paths of tariffs reveals a different view of the impact of the Gasnet tariffs.



Source: Gasnet applications, ACCC FDs, AER DD, AEMO GSoO2012

The chart shows that falling tariffs in AA2 are associated with an increase in gas flows, but the rising tariffs in AA3 are associated with a constraint in gas consumption in the later stages of AA3 and to a significant fall forecast for AA4. For Gasnet to view the retention of high tariffs against falling consumption is efficient is a gross distortion. In fact, lower tariffs in AA4 should encourage greater gas consumption and so lead to a better utilization of the Gasnet assets.

It is clear that the arguments put forward by Gasnet and its consultants do not correlate with the reality that the current high tariffs are associated with reducing gas consumption. On this basis, the reality supports a view that criterion (a) is supported by the lower tariffs proposed by the AER draft decision. The EUCV considers that lower tariffs are required to address the falling consumption that is forecast.

With regard to criterion (e), Gasnet then advises that the lower revenue from applying the same approach it has to depreciation in the past will result in it not receiving sufficient revenue to meet its reasonable needs. To support this contention, it provides a view by Australian Ratings that the revenue afforded by the AER draft decision is insufficient for it to maintain a BBB+ credit rating and would maintain (at best) a credit rating of BBB.

It is important to note that Gasnet's parent (APA Group) has a credit rating of BBB – so the AER draft decision would not impact on APA's ability to raise debt. Gasnet overcomes this inconsistency by pointing out the AER needs to ensure there is internal consistency in the draft decision by ensuring the cash flows for Gasnet equate to the benchmark service provider rated at BBB+ because the cost of debt has been included in the draft decision as if the service provider was rated at BBB+.

There is an essential inconsistency in Gasnet's argument. The assessment by Australian Ratings is that Gasnet would be rated at BBB based on the AER assessed cashflow and its costs to raise debt on the open market would exceed the benchmark cost of debt for a BBB+ rated firm used by the AER. However, the benchmark cost of debt used by the AER for the Gasnet decision is higher than the actual cost of debt incurred by Gasnet's parent APA (which is rated at BBB) when it recently raised debt from the open market. This means that either APA is actually operating at a higher credit rating than is published, or the cost of debt allowed by the AER in its draft decision is higher than cost of debt incurred by a BBB+ rated firm. Either way, there is inconsistency in the Gasnet argument.

At its most basic, the credit rating set for a firm is used to identify the risk premium a lender would impose on a borrower – the lower the credit rating the higher the cost of debt. The setting of the credit rating is secondary to the actual cost for its debt that a firm will incur. Therefore if the AER considers that the cost for debt a regulated firm will actually incur will be lower than the cost for debt it allows within the determination, then the actual credit rating a firm might have is immaterial.

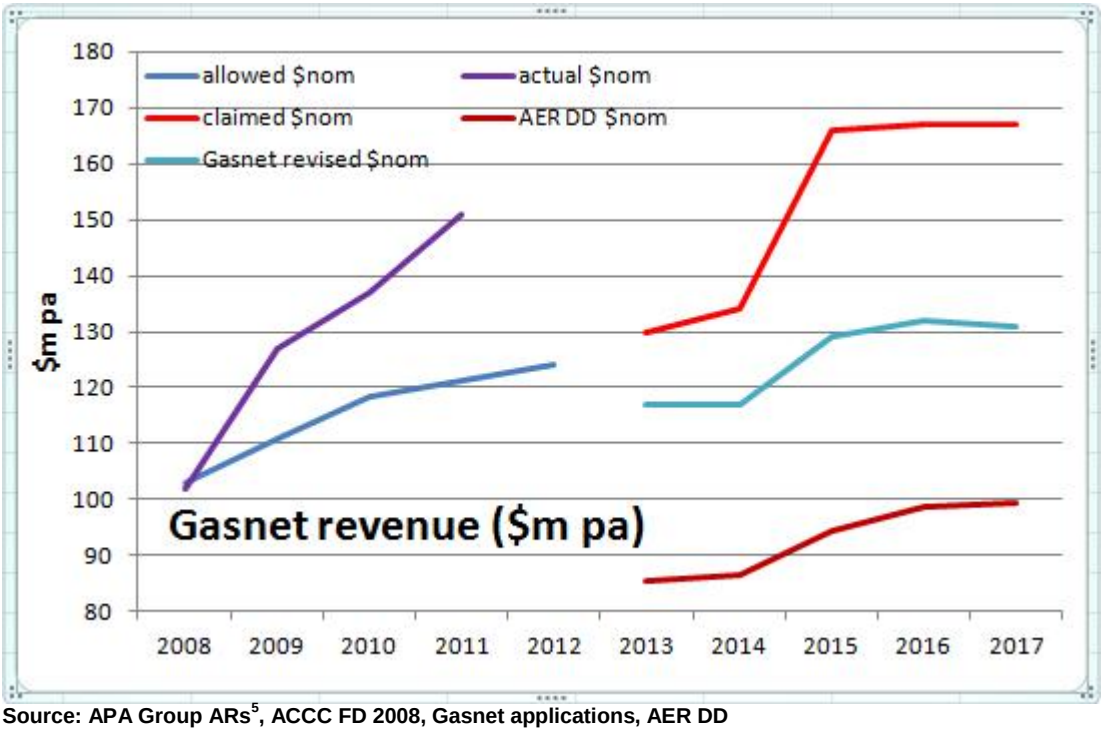
The EUCV is of the view that the AER determined cashflow will be sufficient for Gasnet to acquire its debt at a cost less than the BBB+ benchmark used by the AER in developing the WACC. Therefore the argument that the resultant cashflow would only sustain a credit rating lower than the notional benchmark, is not the issue the AER need address, providing the cost of debt the AER allows is higher than the cost for debt Gasnet is likely to incur. As there is no doubt that the allowed cost of debt exceeds the actual cost of debt then the imputed credit rating from a reduced cashflow is not an issue.

On balance, the EUCV considers that the AER should maintain regulatory consistency and require Gasnet to utilize its historic approach to depreciation.

5.3 Revenue allowed and the impact on consumers

Gasnet initially sought a revenue that shows a marked increase from the revenue seen in the current AA3 period. The actual revenue achieved, the allowed revenue for AA3 and sought for AA4 in the Gasnet application and

revised application, and the revenue allowed in the AER draft decision are shown in the following chart

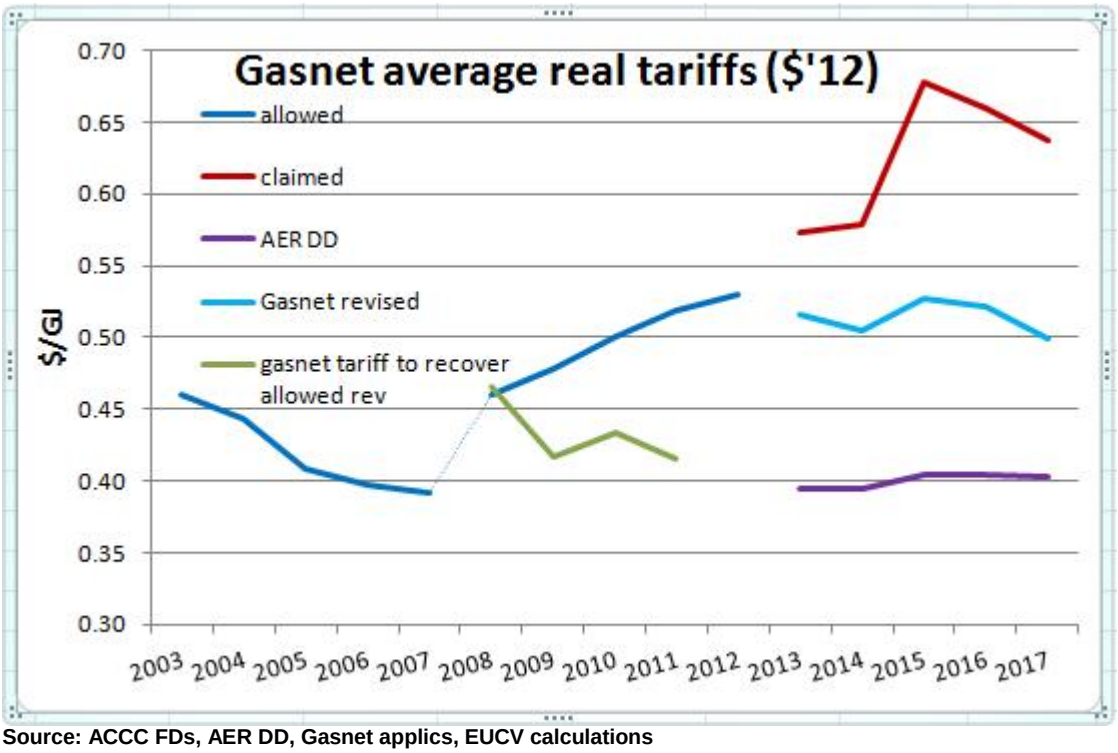


Source: APA Group ARs[5], ACCC FD 2008, Gasnet applications, AER DD

It is clear that the AER considers that the revenue Gasnet should receive will be a considerable reduction to the revenue allowed by the ACCC in 2007. The fact that Gasnet achieved considerable more revenue than was allowed implies that the tariffs set in the ACCC final decision in 2007 were too high – after all, the expected outcome for Gasnet would be that it would recover the revenue the ACCC deemed was efficient. Therefore the ACCC either made an error in its development of the allowed revenue or underestimated the expected gas flows, or a combination of both. Either way, the tariffs set by the ACCC were too high and allowed Gasnet to over-recover its allowed revenue.

To assess what the tariffs needed to be to allow Gasnet to recover its allowed revenue from the ACCC 2007 final decision, the EUCV has provided in the following chart (along allowed average tariffs for AA2 and AA3 from earlier decisions and the average tariffs for AA4 from the AER draft decision, the Gasnet application and the revised Gasnet application) a notional average tariff (in green) that would have been applied to ensure Gasnet received its allowed revenue for AA3.

[5] 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 than were in the compliance reports.



Source: ACCC FDs, AER DD, Gasnet applics, EUCV calculations

This analysis provides a useful insight into tariff movements over time. The allowed tariffs for AA2 trended down to about $0.40.GJ, and the tariffs to match the allowed revenue for AA3 show an initial rise but falling to about $0.40/GJ. The average tariffs calculated from the AER DD show that the tariff would be about $0.40/GJ which is consistent with tariffs that would have recovered Gasnet allowed revenue in AA3 and with AA2 tariffs.

The EUCV recognises that such analysis is simplistic and does not reflect the risk faced by Gasnet from gas consumption changes, but it does provide an indication that the AER draft decision tariffs are more consistent with historic levels than either of the Gasnet average tariffs derived from its application or revised application.

This supports the view that the AER draft decision allowed revenue provides a more reasonable outcome than either of the Gasnet assessments.

5.4 Pass through events

The EUCV notes the proposed arrangement for pass through events proposed by the AER but considers that the AER has been lax in allowing consumers to take these additional risks, bearing in mind that Gasnet is receiving such a high equity beta compared to its actual risk profile. Its comments provided in its response to the Gasnet application are still applicable.

The EUCV notes the comments and changes proposed in the Gasnet revised application. The EUCV considers that the transfer of risk to consumers inherent in the changes is not commensurate with the rewards Gasnet seeks and risks it faces.

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 was seen in AA3, there was more gas transported than was assumed in the development of the Gasnet tariffs and therefore Gasnet received 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 EUCV notes that the AER draft decision required Gasnet to make significant changes to the tariff development methodology and that most of these have been accepted by Gasnet.

The EUCV remains concerned that tariff development for price cap regulation remains an area for regulated firms to “game” the regulatory process and so more than recover their allowed revenue. This practice imposes costs on consumers that are not efficient.

The AER has identified that from outcomes for other regulated firms, actual revenue has considerably exceeded allowed revenue, even after adjusting for changed volumes of energy transported. The EUCV supports the AER increased attention to this aspect of regulation.