



Major Energy Users Inc.

19 February 2013

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

By email: AERInquiry@aer.gov.au

Submission re: Draft Decision on Murraylink application for a revenue reset

Dear Mr Anderson

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

1. Duration of access arrangement

In its initial application, Murraylink sought a new 10 year access arrangement. The AER permitted this and its draft decision is based on this duration for the next regulatory period. In its revised application Murraylink has decided that a conventional 5 year access arrangement will meet its needs. The MEU does not consider that the shorter period will be detrimental to consumers.

However, the MEU does note that with a 5 year access arrangement, all of the inputs to the costs allowed by the AER should correspond to this shorter period. In particular, the MEU considers that the basis for the WACC development should reflect the shorter regulatory period. This approach was instituted by the ERA of WA for its decision on Western Power. Although the WACC decision in 2009 sets specific values for a number of WACC inputs (and therefore these cannot be varied), there is no set value for debt risk premium. As the access period is of five years duration, the MEU considers that the DRP should likewise be based on debt acquired for a 5 year period.

2-3 Parkhaven Court, Healesville, Victoria, 3777

ABN 71 278 859 567

Other cost inputs will also be affected by the decision to have a shorter regulatory period, such as capex needs. The MEU comments on capex and other inputs to reflect the shorter period are detailed in the following sections.

2. Efficiency of services provided by Murraylink

In the 2003 decision by the ACCC allowing Murraylink to be regulated, the ACCC made a significant determination, with which the MEU strongly concurs. The ACCC determined that there were lower cost methods of delivering the same services provided by Murraylink as the technology used by Murraylink was inappropriate for a regulated augmentation of the national transmission network. Further, although Murraylink was costed by the ACCC as a 220 MW capacity link, constraints in the ElectraNet and SP Ausnet transmission systems feeding Murraylink, preclude it from operating at this level for most of the time. This means that for the bulk of the time a lower capacity link than 220 MW would reflect greater economic efficiency. Overall, Murraylink is both oversized (compared to the constraints in the networks it is connected to) and uses inappropriate technology.

The AER (and its consultant) quite rightly identified that Murraylink is significantly underutilised and that it incorporates considerably more equipment than is required to provide the service it now does. These observations raise four critical issues for consumers.

Firstly, due to the underutilisation of the network, the hardware has not been stressed to any great extent and so there is an expectation that the equipment will have a much longer life than equipment that has been operated at its rated capacity. To a degree, the AER (and its consultant) has recognised this in its draft decision by stating that replacement of equipment should be based on condition monitoring rather than fixed timeframes. The MEU agrees with the AER on this issue (that condition monitoring is the main driver of replacement) and is the practice followed by companies operating in a commercial environment.

Secondly, there is equipment included as part of the Murraylink assets that is not necessary for a “free flowing” transfer of power. The regulatory value set by the ACCC for Murraylink is based on a conventional AC interconnection. Unique features that Murraylink provides because it was established as a Market NSP are not necessary for the free flow of power that it is now required to provide. These unique features have been assessed by the ACCC as having no value to consumers and therefore were excluded from the asset base. Following this logic, to replace them or keep them in operation is not efficient and not in the interests of consumers.

Thirdly, the valuation of Murraylink by the ACCC was based on a more efficient concept than the DC link provided. Implicitly, the opex and capex needs of Murraylink should be based on the costs applying to the base design concept used

by the ACCC to value the assets as part of the determination allowing Murraylink to be regulated. Essentially, the capex and opex allowances should be those applying to the lower cost AC link that the ACCC decided was the most appropriate alternative. This means that the opex and capex allowances should reflect the needs of the most efficient solution to the transfer of power rather than the inefficient method actually implemented.

Fourthly, it must be remembered that the ACCC established the RAB on the basis that 220 MW could be transferred on the assets. In practice, this seldom occurs and now, an even lower cost would be assessed to reflect the real value of the assets to consumers as the link cannot provide its full rated capacity at the times most needed¹. Put another way, based on its actual performance, the ACCC must not assess the RAB on a 220 MW but on one with a much lesser capacity. This means that the RAB is overstated for the service that is delivered.

Overall, the MEU considers that the opex, capex and depreciation allowances should reflect those costs that would have been incurred if the assets had been built to provide the most efficient outcome. The fact that the ACCC did not accept the value of the assets actually provided by Murraylink and valued the assets as if they provided the same service at a lower cost clearly shows that costs which are related to the actual assets will be inefficient and not applicable.

To impose on consumers costs related to the provision of a service based on using inefficient assets is not in accord with the National Electricity Objective (NEO).

3. The correct approach to valuing the allowances for Murraylink

As noted above, the MEU considers that the capex and opex allowances should relate to the assets needed for a design based on delivering the most efficient outcome for consumers.

To test the capex and opex allowances needed for an interconnector designed for the service now provided, the MEU looked to benchmark the costs of the capex and opex to be allowed. As Murraylink connects SA and Victoria, the MEU has looked at the capex and opex needs of ElectraNet and related this to its RAB value at the start of the next period established in the recent draft decision. The MEU sees that relating capex to RAB is just one benchmark and, although it is not perfect, it does provide some relativity and a reasonableness test.

Benchmarking from just one measure from just one TNSP is not best practice and the MEU recognises that other benchmarks based on more than one TNSP should be used.

¹ Another way of explaining this concern, is that if a TNSP had proposed an interconnect, it would have had difficulty in demonstrating under a regulatory test that the interconnector should be sized for 220 MW, particularly as the transmission networks in Victoria and SA are not sized to accommodate such a flow.

However, the MEU did note that a straight benchmark comparison (regardless of its derivation) would be inappropriate in this case as all of the Murraylink assets are all only about 10 years old and the average age of assets provided by all the Australian TNSPs are significantly much greater. This means that there needs to be an adjustment of the RAB values to bring the RAB values to a common age if the RAB based benchmark is to have credibility.

As ElectraNet assets are more than 30 years old, its start RAB value needs to be adjusted to the same age that Murraylink assets have if it is to be used as a benchmark. The start RAB for the next period calculated by the AER in its draft decision for ElectraNet is \$2,078m². The MEU adjusted this value using the age profiles provided in the ElectraNet application³ and calculated a new ElectraNet RAB value as if the ElectraNet assets had the same age as the Murraylink assets⁴. This resulted in an adjusted ElectraNet starting RAB of some \$4,600m if the assets were all 10 years of age. This compares to the Murraylink starting RAB for the next period of \$107m⁵.

The MEU considers that, as a benchmark test, the capex and opex allowances for Murraylink can be related to the Murraylink RAB value, as this is based on the ACCC assessment of the most efficient method to deliver the service provided.

On this basis, the MEU sees that the benchmark performance of Murraylink would be 2.3% of the AER capex and opex allowances for ElectraNet.

4. Capex

In its response to the Murraylink application, the MEU pointed out that Murraylink was seeking a massive rise in its capex and that forecast capex was a significant step increase from the historical performance. In its draft decision the AER analysed the detail of the capex claim and made significant reductions to the forecast capex.

The MEU does not have access to detailed information as to the actual needs for the capex but does note that much of the capex relates to the type of equipment specific to the design of the interconnector which was implemented so that Murraylink (as a Market Interconnector) could arbitrage the difference in spot prices between the two regions connected. This means that the basic design of Murraylink has features that are not needed for the free flow of power that is implicit in the ACCC assessment of the value to consumers that Murraylink provides. It also means that some of the

² Table 6 in the AER ElectraNet DD 2012

³ Figure 3.6 in ElectraNet application 2012

⁴ The MEU calculation used the regulatory depreciation approach to asset value changes, based on a 40 year average life (ie annual depreciation of 2.5%) and 2.5% inflation and compared the asset life after 10 years with the asset life after 30 years. The MEU acknowledges the coarseness of this approach but sees that it does provide a mechanism to adjusting for differences in age profiles

⁵ Table 5.1 in the AER Murraylink DD 2012

equipment provided and, although needed to provide the service, has a shorter life span than equipment used in a conventional AC transfer arrangement.

The AER draft decision halves the Murraylink average annual capex sought from \$1.38m pa (\$13.8m over 10 years) to \$0.73m pa (\$7.3m over 10 years), but with the bulk of the capex occurring in the first 5 years.

The capex the AER allows in its draft decision for the first 5 years is \$5.2m (some 70% of the capex sought for the 10 year period) or an annual average of \$1.04m pa over the 5 years. This AER allowance is a step increase of 123% above the actual highest annual capex Murraylink incurred in the previous 10 year AA1 regulatory period. On this measure alone, the AER draft decision appears to be excessive.

Murraylink has revised its application to have a 5 year regulatory period and it now claims capex of \$6.3m over 5 years or an annual average of \$1.26m pa. This represents a 180% step increase above the forecast 2012 capex expenditure and is higher than the annual average capex allowance provided by the AER in its draft decision.

As a benchmark capex allowance, the AER draft decision for ElectraNet for the same time period is an annual average of \$128m pa. Adjusting this using the adjustment factor calculated in the above section 3 (ie Murraylink having capex based on 2.3% of the ElectraNet allowance) the benchmark capex would be an annual allowance of \$2.94m pa. This allowance is considerably higher than the annual average capex of \$1.04m pa the AER applied in the first five years of the 10 year period it assessed. It is also considerably higher than the revised annual capex of \$1.26m pa that Murraylink includes in its revised application.

Based on the simplistic external benchmarking, the AER draft decision and the Murraylink revised capex allowances would appear to be reasonable. However, the historic self benchmark that Murraylink actually achieved over a 10 year period, indicates that both the AER draft decision and the Murraylink revised applications are excessive.

5. Opex

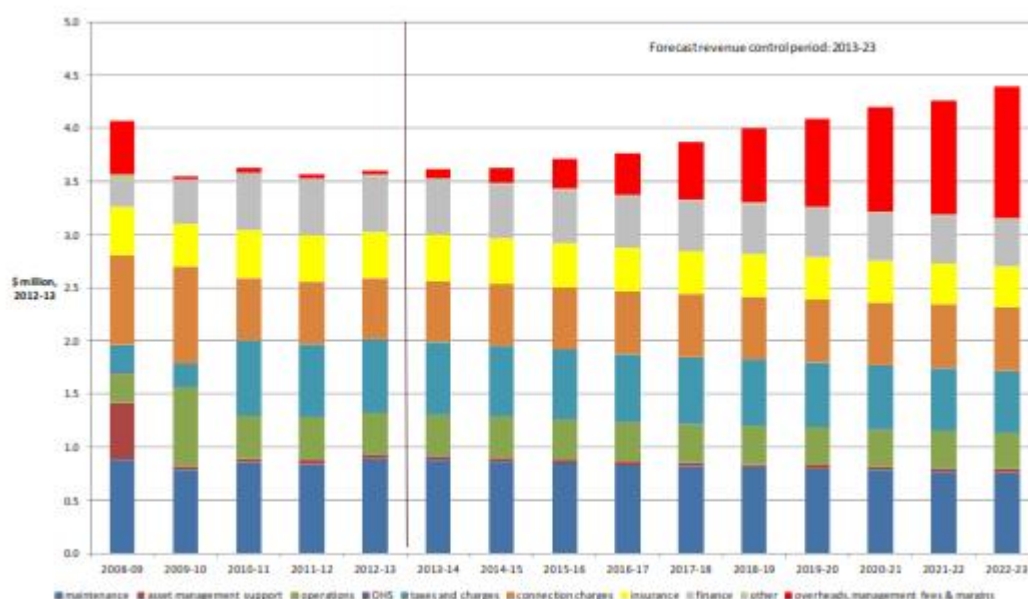
Historic opex by Murraylink shows a consistent trend, although the data provided by Murraylink does not cover the entire 10 year period of AA1 – in fact, it only shows three years of actual costs and two years of forecast costs. The MEU notes that the AER has not sought actual data prior to 2009 to see the longer term trend as might be expected when forecasting ahead for 10 years. This shows an obvious deficiency in the assessment by the AER which should be rectified.

A further deficiency in the AER's assessment is to assume that the base year 2011/12 is efficient despite there being no incentive scheme (such as an efficiency

benefit sharing scheme – EBSS) applying for AA1 which is intended to give confidence that the base year is demonstrably efficient.

The AER draft decision does examine in some detail the specific elements which comprise the entire opex and the AER figure 3.2 provides two quite interesting observations that can be made about the Murraylink forecast opex included in its initial application.

Figure 3.2 Murraylink's actual/estimated and proposed opex by cost category, 2008–23 (\$ million, 2012-13)



Source: Murraylink, *Cost information template*, May 2012 and AER analysis. Note: does not include debt raising costs.

The first and obvious aspect is that Murraylink was including ever increasing amounts of “overheads, management fees and margins” (shown in red). This is despite the fact that essentially the service Murraylink provides does not change at all over the forecast 10 year period. This issue of overhead, management fees and margin was in part raised by the MEU in relation to the Murraylink application but has been frequently raised by the MEU in relation to other regulatory reviews where the service provider out sources considerable amounts of work to related parties and not always on an arms-length basis. The MEU is pleased that the AER has addressed the issue of related party transactions in this case.

The second aspect of the AER graphical analysis is that direct elements of the opex costs show a distinct and consistent reduction over time. In fact, total opex less overheads, management fees and margin was forecast by Murraylink to reduce by at least 1% pa cumulatively over the 10 year period.

The AER has reduced the allowed opex by 15% from that initially sought by Murraylink. In its revised proposal, Murraylink has basically retained its initially

proposed opex and made little adjustment to the opex as a result of the AER considered views as to what constitutes acceptable levels of opex.

Whilst the AER has used the historic performance of Murraylink to inform itself of the appropriate opex based on self benchmarking, it has carried out no other comparative benchmarking at all.

Using the AER draft decision for ElectraNet, the AER has allowed opex for ElectraNet of some \$397m or an annual average of \$79.4m pa. Applying the scaling factor developed in section 3 above (ie Murraylink having opex based on 2.3% of the ElectraNet allowance) the benchmark opex for Murraylink would be an annual allowance of \$1.83m pa. This benchmark is considerably lower than the AER draft allowance and the opex claimed in the revised proposal.

Based on this simple analysis, it would seem that both the AER draft decision and the revised proposal include opex allowances that are not consistent with the opex costs that might be expected if the interconnector had been built to the most efficient design.

6. Cost escalators

The MEU notes that the AER has required Murraylink to base its cost escalators on the Deloitte Access Economics (DAE) labour price indices unadjusted for productivity. In its revised application, Murraylink accepts this draft decision of the AER.

The MEU also notes that Murraylink has not sought a real increase in the price of materials into the future and this has been accepted by the AER.

In its response to the draft decision on Gasnet, the MEU affiliate Energy Users Coalition of Victoria (EUCV) considered that the AER was incorrect in not using productivity adjusted labour price indices and that allowing regulated firms to seek real cost increases in materials when prices rose, but to accept CPI adjustments when material prices fall, does not provide a symmetrical outcome for consumers – effectively this approach provides for a “heads the NSP wins, tails the consumer loses” outcome.

The MEU provides, as appendix 1, the commentary made by the EUCV in its response to the draft decision by the AER on the Gasnet application (an APA owned entity) which addresses the MEU concerns with the AER draft decision regarding cost escalators.

However, despite the fact that the AER has elected not to impose productivity adjusted labour price indices, it has separately imposed a 2.5% pa efficiency

improvement assumption on input costs based on the productivity improvements that can be expected.

The MEU agrees that both a productivity adjustment embedded in the labour price index and an efficiency improvement gain should not be applied, but it is firmly of the view that one of them should be included in the final allowances.

7. Depreciation

The MEU notes that the AER draft decision changes the approach the depreciation sought by Murraylink. The MEU considers that the AER is correct to address this issue but considers that the AER has not addressed the issue to the fullest extent possible. The decision to regulate Murraylink was predicated on the concept that the most cost efficient approach was a free flowing AC link. This asset value should be depreciated on the assumption that the link uses assets that have the same engineering life as those used to develop the initial cost base. To allow depreciation to be based on the life of assets that were not used to develop the initial asset base exposes consumers to costs that they would not have been exposed to had the interconnector been constructed in the most efficient manner. It would not be efficient to allow depreciation to be based on the lives of assets that were inappropriate for the most cost effective base for the service required. This is a very important determinant of whether the AER review is consistent with the NEO.

The MEU therefore does not consider that the depreciation of assets should be faster than the expected life of assets which would have been used to provide the most cost effective solution for the service being provided. This would provide consistency with the AER's treatment of other elements of the initial and revised applications.

8. The WACC draft decision

The MEU recognises that the WACC parameters are set for electricity transmission firms and this allows little scope for change from those set at the WACC review in 2009. The only aspect of the WACC parameters that has any flexibility is the setting of the debt risk premium (DRP).

In the draft decision, the AER commented that the MEU observations regarding the use of the historical cost of debt incurred by APA (a part owner of Murraylink and its operator) as the basis for setting the DRP was not appropriate for use in developing a forward looking cost of debt and the associated DRP. The MEU accepts this criticism but does highlight that the debt risk premium sought by Murraylink and that proposed by the AER in its draft decision equally is inappropriate because it patently provides an outcome which is far in excess of the actual debt risk premium required by a BBB+ rated entity.

The AER has continued to place its Statement of Regulatory Principles – SRP – (which it uses to identify the allowed DRP) above the requirements of the National Electricity Objective and the National Electricity Law on the premise that regulatory certainty is more important in determining an efficient cost of debt. There is no doubt that the application of the SRP provides an outcome that is too high and is not reflective of the actual costs of debt. This observation is supported by the fact that the actual costs of debt incurred by APA (considered to be a prudent service provider) result in a DRP which is significantly lower than that calculated using the AER developed SRP.

For the AER to state that its SRP process for setting the DRP provides an efficient cost for consumers, is patently false and not supported by observable facts. By using an unnecessarily high DRP, the AER is imposing on consumers an inefficient cost which unnecessarily increases what they are required to pay for the service.

The Murraylink revised application accepts the AER draft decision on the DRP. This is small wonder as Murraylink will be able to generate a significant unearned profit from the AER draft decision which is just as flawed as the MEU approach which the AER feels justified in criticising.

The MEU would be pleased to expand on the issues raised in this submission and suggests the AER contact the undersigned to discuss the MEU concerns raised in this response.

Yours faithfully

David Headberry
Public Officer

Appendix 1

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:

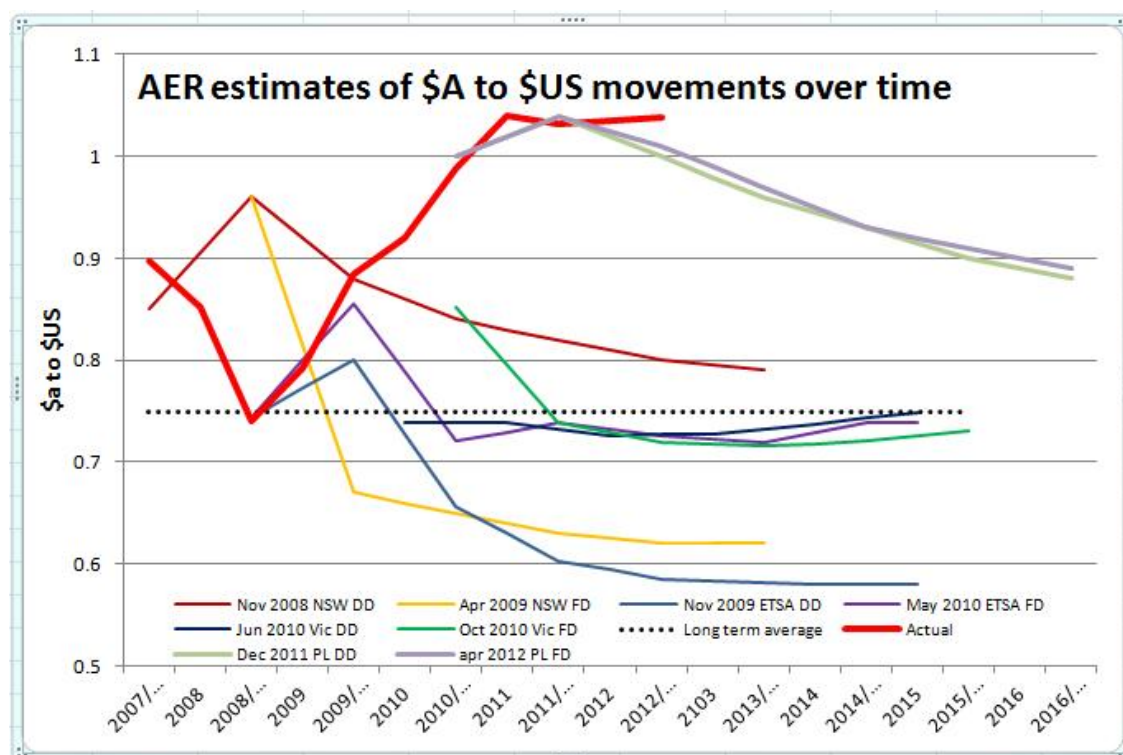
“The AER considers that in theory productivity adjustments should be applied to real cost escalations if productivity adjustments are not undertaken elsewhere in opex and capex forecasts.

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 does 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.