Major Energy Users Inc.

Australian Energy Regulator

Transmission Guidelines

Comments on the Draft Guidelines

by

The Major Energy Users Inc

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Executive Summary

The draft AER Guidelines, unfortunately, are constrained by the AEMC's Final Rules Determination on electricity transmission revenues, which is overly prescriptive, and mandates a decisive shift in economic regulation in favour of TNSPs to the detriment of consumer interests.

The draft AER Guidelines also clearly reflect the short time lines given to the AER by the AEMC's late Final Rules Determination. As a result, many details and approaches have been lifted directly from the ACCC's Statement of Regulatory Principles for transmission networks, and do not adequately consider the major changes in regulation following the AEMC's Determination.

Accordingly many of the MEU's comments are an attempt to encourage AER reflection and consideration of detailed issues that arise because of the AEMC changes.

One issue common to all is that there is no specific time by when the AER will assess the ability of the guidelines to provide the correct direction for TNSPs to take. The MEU considers that all such guidelines must have a review date so that the preceding experiences can be integrated into them for the future. The MEU strongly recommends that there be a formal review of all guidelines developed by the AER within two years of their implementation.

Comments on specific issues are provided on:-

2. PTRM

Benchmark financial indicators
As the Rules no longer require the regulator to prepare such financial indicators, the AER now has to develop a guideline that will demonstrate that the outcome of the review will be equivalent to that achieved by an efficient benchmark entity.

WACC
The MEU concludes from its review of the AEMC Final Determination that there is little flexibility permitted to the AER in assessing an appropriate WACC, and that the guideline must essentially reflect the decisions made by the AEMC and which are clearly detailed in the Rules.

Debt premium
There are a number of approaches used to identify the actual premium implied by this Rule. The AER needs to be explicit as to how it intends to

identify the most appropriate method for setting this debt premium bearing in mind that the outcome needs to be reflective of that which would apply to an efficient benchmark entity.

The value of depreciation
The MEU is concerned that the approach to depreciation can be a tool for increasing or decreasing the impact of costs today, on future users. It therefore suggests that the AER implement a comparative analysis of the depreciation process proposed by a TNSP to identify that there is no unjustifiable transfer of costs between current and future users. In this regard MEU would suggest that the inflation rate is used as a the deflator of future costs.

Changing depreciation approaches between resets
The MEU considers that TNSPs be required to fix the approach to depreciation and not be permitted to vary the approach in later resets, unless the regulator considers that such would not be contrary to the interests of present and future users.

Notional start of depreciation
Investments made by MEU members have as long a lifespan as those of TNSPs. MEU member companies do not get any return (on assets or working capital) in developing any of their assets until the assets are producing product. There should not be any special treatment for TNSPs.

Regulatory control period
The AER should make it clear how it proposes to extend the model to accommodate different regulatory periods, and what assumptions and calculations will achieve a consistent outcome in the model for a “non-standard” regulatory period.

The impact of timing assumptions
The MEU has a concern that the approach suggested by the AER might entrench a bias in favour of the TNSPs. In order to assure that the AER approach is equitable, the MEU suggests that the AER carryout a quarterly cash flow analysis using quarterly CPI adjustments to demonstrate that their approach does not provide any bias detrimental to consumer interests.

3. Roll forward model

Depreciation and capex are the key inputs to the roll forward calculation. Whilst it is accepted that the AEMC has provided a high degree of prescription on the AER in relation to WACC and depreciation, and a high

measure of flexibility to the TNSP as to their preferred approach to depreciation, this should not provide a TNSP with enhanced outcomes at the expense of consumers. The AER's guideline should provide more detailed requirements to demonstrate what is changed and the impact of these changes sought by the TNSP.

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4. Efficiency sharing

Incentive to manage capex

The MEU considers that there is little in the incentive scheme proposed by the AER to encourage the business to seek to minimise capex and share the benefits with consumers. Further, the MEU sees that capex allowances are likely to be "gamed" by the businesses, effectively destroying the benefits of any incentive arrangements put in place.

The MEU has therefore come, albeit reluctantly, to the conclusion that any incentive scheme proposed for capex under the current regime is doomed to failure.

Having stated this, it is pointed out in section 4.3 that as opex and capex are intertwined, to allow capex to over run and so allow a maximum benefit for opex should not be supported. There is support for an incentive scheme for opex, but any opex benefit carried forward should be discounted for any capex over run ie where there would have been a negative carryover from a capex incentive program

Incentive to manage opex

It is obvious that the businesses attempted to "game" the regulator and were partly successful to an extent. Certainly much of the early year under-runs were not passed through to consumers, but the benefit of the difference between allowed and actual in 2004 was passed onto consumers.

It is on this basis that MEU considers that there are valid reasons to support an incentive scheme for opex.

Other regulatory issues:

The MEU suggests that a regulatory incentive scheme should be assessed each five years (or part thereof) regardless of the duration of the reset. An incentive should only be carried forward for a five year period

The amount at risk

The AEMC increased the amount at risk for a sound reason – to encourage better performance by the TNSP as part of the overall

revised TNSP regulatory regime. The AER has unilaterally countered this part of the regulatory package.

However the Rules are explicit – it is the TNSP that selects the amount of revenue to be at risk, and not the AER. The AER has the power to decide if a TNSP proposal does not comply with the Rules.

If the AER wishes to be conservative, it might suggest that as a starting point, the TNSP has the right to select its own limit of revenue at risk, but capping this for the first reset after the current period, at 3% of revenue[1]. At the following review, the 5% limit should be set.

5. Service performance targets

Measures

It is noted that none of the proposed measures relate to service performance which measures availability of the network when it will deliver the greatest benefit to users, nor is there any reference to availability when determining spot prices.

What is required is a measure which reflects value to users. As a start the MEU suggests that there must be a review of previous performance and demand on the networks at times of greatest demand and times of the highest regional spot prices.

Thus MEU would suggest that frequency of loss of supply (even for a second) should be measured.

Weightings

It is expected that there will be a number of performance targets set, and so there must be a method for allocating the weighting of each performance target. Those with the greatest weighting must be those that achieve the basic goal espoused in the Rules.

Conclusions

The MEU considers that the AER has not carried out sufficient investigation into identifying what service parameters mean most to

[1] 3% is halfway between 1% and 5%

consumers, nor has it identified those parameters which will provide the most impact in relation to spot prices.

6. Proposal and information provision

The MEU considers that the AER has identified the bulk of the information that should be provided with the TNSP proposal. There are four additional aspects of information provision that the MEU considers need to be added to the guidelines – historic opex and capex, step changes, competition benchmarking and indicative pricing.

7. Cost allocations

The MEU considers that overall the AER guideline on cost allocations between different services has been well addressed and provides a high level approach to what is the required outcome for cost allocations.

Notwithstanding this support for the guideline, there remains one major concern for consumers. Once the Rules for cost allocation have been stated and agreed between the AER and the TNSP, there requires a verification process to be instituted to verify that the agreed process has been used in the actual allocations.

The AER should establish an audit process (perhaps based on the principles of quality assurance) to verify that costs have been allocated appropriately.

1. Introduction

The MEU

The Major Energy Users (MEU), which comprises some 20 major energy using companies in NSW, Victoria, SA, Tasmania and Queensland, welcomes the opportunity to provide comments on the AER's draft electricity transmission revenue guidelines. In particular, the submission represents the views of the Energy Markets Reform Forum (NSW), Energy Consumers Coalition of South Australia, the Energy Users Coalition of Victoria, the A3P and the Cement Industry Federation.

Analysis of the electricity usage by the members of MEU shows that between them they consume about 5% of the electricity generated in the NEM. Many of the members are located in regional parts of Australia, some distance from the regional nodes. As such, they are highly dependent on the transmission network to deliver efficiently the electricity so essential to their operations. Being regionally located, those members also have an obligation to represent the views of their local suppliers and of the regionally based workforce on which the companies are dependent. With this in mind, the members require their views to not only represent the views of large energy users but also those of smaller power usage facilities and residences located near to their regional operations.

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

Although electricity is an essential source of energy required by each member company in order to maintain operations, a failure in the supply of electricity or gas effectively will cause every business affected to cease production, and members' experiences are no different. Thus the **reliable supply** of electricity and gas is an essential element of each member's business operations.

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

Each of the businesses represented here has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **sustainability** of energy supplies is required. If sustainable supplies of energy are not available into the future these investments will have little value.

Accordingly, MEU is keen to address the issues that impact on the **cost, reliability, quality** and the long term **sustainability** of their gas and electricity supplies.

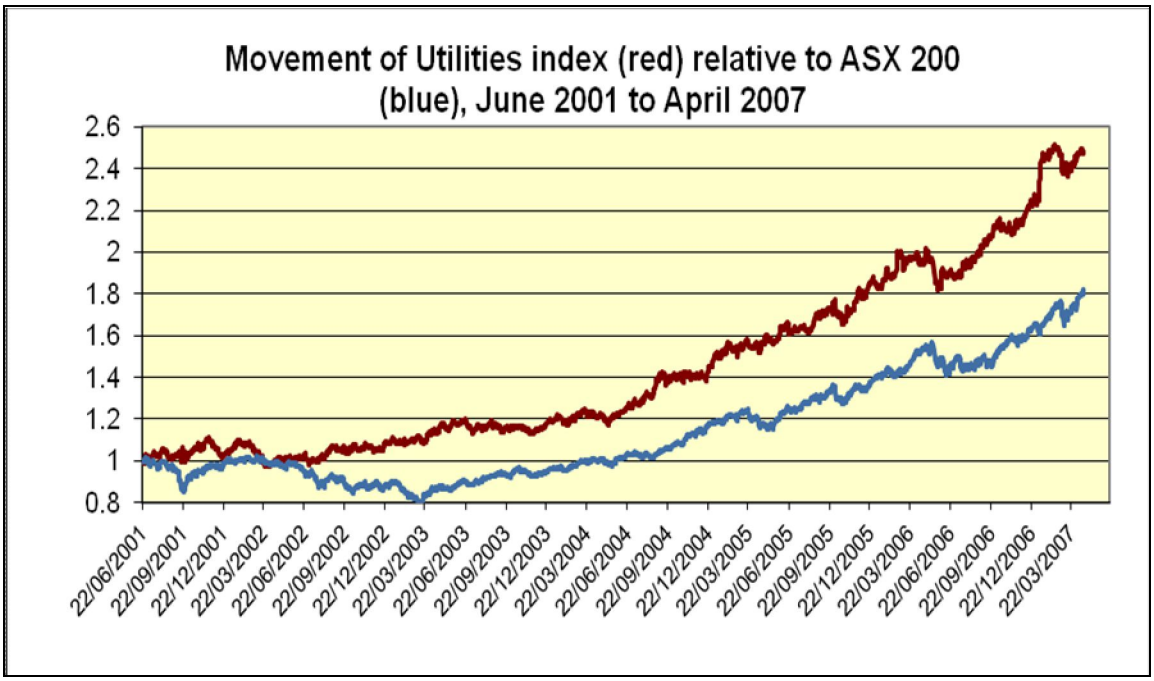
The members of MEU have identified that transmission plays a pivotal role in the electricity market. This role encompasses the ability of consumers to identify the optimum location for investment in its facilities and providing the facility for generators to also locate where they can provide the lowest cost for electricity generation. Equally, consumers recognise that the cost of providing the transmission system is not an insignificant element of the total cost of delivered electricity, and due consideration must be given to ensure there is a balance between the two competing elements.

As consumers are the prime providers of funds to support the transmission network, they see that transmission is a tool for reducing the market power held by generators. It is the capacity (or the lack of it) of the transmission network that results in major price separations between regions, frequently causing large costs to consumers as a result of these separations.

Consumers have observed that transmission companies have a low risk in their market operations, especially compared to down stream industry which by and large is greatly exposed to competition (which drives industry to consistently seek lower cost approaches to reduce their costs and so remain competitive). The MEU sees that with their guaranteed (regulated) revenue stream and their unique natural monopoly position regulators must ensure that there is optimum pressure on transmission network businesses to perform their functions to achieve the maximum benefit for consumers but maintaining a low cost base reflecting the protected nature these businesses have. Regulators must also ensure there are adequate (but not excessive) returns to these businesses.

In this regard, it is pertinent to highlight that businesses such as electricity transmission businesses have achieved very good financial performances. Yet these businesses have returned to their shareholders a dividend and market price growth that vastly exceeds that of industry in a competitive environment. This can be demonstrated by comparing the market performance of these businesses compared to those subject to strong competition.

Since 2001, the ASX has developed an index which tracks the market performance of utilities which provide essential services and are either the totally dominant or monopoly provider for the services they provide. The following chart shows the performance of the Utilities sector of the ASX 200, compared to all businesses in the sector.



Source: CommSec

At the same time the dividends paid by Utilities have exceeded those paid by all ASX 200 companies by over 20%[2]. Thus it is quite clear that the Utilities are enjoying both yields and growth in excess of the industry average. The AER should bear this significant out performance position when setting the guidelines for transmission reviews.

Consumers see that careful increases in the capacity of the transmission system will result in lower costs of generation, and by transmission companies providing more “up time” of their networks at critical times will also provide a foil for the exercise of generator market power.

Against the above background, the MEU appreciates the opportunity to review and comment on the draft guidelines for the regulation of electricity transmission revenues.

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[2] See appendix A

2. Post tax revenue model and the AEMC Final Determination

The key aspects of the AER guidelines relate to the following issues:

1. Return on capital (WACC)
2. Return of capital (depreciation)
3. Regulatory control period
4. Consistency of timing
5. Other regulatory matters

In its requirement for consistency the AEMC decided in its Final Rules determination that of the various models for developing the permitted revenue for a TNSP, the most appropriate was the post tax revenue model (PTRM).

The other models developed a WACC which provided a range of returns which (in theory) are identical. These include such approaches as a pre tax real return, a vanilla WACC, and others.

The challenge faced by regulators in determining regulated revenues is that whereas a business in a competitive environment provides a return based on its trading performance, the regulated business has its return developed from what are statistical outcomes from competitive market analyses. What is obvious from the outperformance of the regulated businesses as measured by the Utilities Index of the ASX (see section 1 above), is that regulated businesses are seen as very attractive businesses to invest in, due to their higher capital growth and higher dividends and relatively low risks.

What is of most concern to consumers is to ensure that the returns granted to TNSPs must be comparable to those returns earned by competitive businesses operating in Australia.

In its final decision on using the PTRM, the AEMC noted[3] that

> "The Commission intends its definition to give effect to the codification of current regulatory practice under the SRP. Therefore, for the avoidance of doubt, the Revenue Rule specifies that the estimated taxable income should be that of an efficient benchmark entity as determined in accordance with the PTRM."

[3] Rule Determination Economic Regulation of Transmission Services Rule 2006 No 18, November 2006 page 91

This requirement on the AER in developing its guidelines clearly states that the model must give an answer which demonstrates that the taxable income should be that of an efficient benchmark entity as determined in accordance with the PTRM.

In other parts of that determination, the AEMC points out that the flexibility of depreciation approach permitted to the TNSP (for example on page 68) when used in conjunction with a pre tax model might well militate against the long term interests of consumers, especially when used with accelerated depreciation.

In addition to the approach to taxation, the AER is required to assess what is the appropriate value for debt premium above the nominal risk free rate used.

What is absent from the draft AER guidelines is how the AER intends to fulfill the requirement of the Rules, which states that the taxable income should be that of an efficient benchmark entity.

Previously the ACCC would prepare a statement of financial indicators which went some way to demonstrating that the taxable income of the TNSP being reviewed provided an indication as to the continued viability of the regulated business. Such indicators also provided a strong indication as to how the regulated business's financial indicators compared to those of businesses in the competitive environment.

As the Rules no longer require the regulator to prepare such financial indicators, the AER now has to develop a guideline that will demonstrate that the outcome of the review will be equivalent to that achieved by an efficient benchmark entity.

2.1 WACC

The new Rules developed by the AEMC require the AER to use the CAPM approach to developing the weighted average cost of capital (WACC). There are a number of assessed inputs that the CAPM requires – a base "no risk return" which in Australia, CAPM is based on the 10 year government bond rate, with additional inputs based on the market.

In its decision on the Rules, the AEMC has determined that there will be fixed inputs until the AER carries out a market review of these in 2009.

The return on capital is to apply to the Regulatory Asset Base as developed from an amount set in the Rules by AEMC, which applies at a specific date. The AER is to develop a roll forward model of the RAB over time using the nominated start

dates. The Rules as developed by the AEMC require that capital actually spent each year by a TNSP is to be added to the starting RAB, adjusted only for inflation and depreciation.

The WACC developed from the 10 year government bond rate using the determined input values, and others assessed by the TNSP (and reviewed by the AER) will constitute the return on capital.

The MEU concludes from its review of the AEMC Final Determination that there is little flexibility permitted to the AER in assessing an appropriate WACC, and that the guideline must essentially reflect the decisions made by the AEMC and which are clearly detailed in the Rules.

2.2 Debt premium

Under the Rules 6A.6.2(e) the AER is to identify the debt risk premium. The Rule states

> "The debt risk premium for a *regulatory control period* is the premium determined for that *regulatory control period* by the *AER* as the margin between the 10 year Commonwealth annualised bond rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a BBB+ credit rating from Standard and Poors and a maturity of 10 years."

There are a number of approaches used to identify the actual premium implied by this Rule. The AER needs to be explicit as to how it intends to identify the most appropriate method for setting this debt premium bearing in mind that the outcome needs to be reflective of that which would apply to an efficient benchmark entity.

2.3 Depreciation

The AER is required to accept a proposal from the TNSP for depreciation. There are only two requirements that a TNSP must reflect, viz

- each asset (or group of assets) is to be depreciated over its economic life, and

- each asset is to be depreciated only once, and the total sum of the allowed depreciation over the asset's life is to equal the initial value at which the asset entered the RAB.[4]

There is no requirement that the depreciation is to reflect the depreciation approach used by the Australian Tax Office (ATO), nor that there should be a consistent amount of depreciation incorporated over time.

The MEU has **three fundamental concerns** about depreciation.

2.3.1 The value of depreciation

The assets used by TNSPs have an extraordinary long operational life, with depreciation being carried out over 60 years or longer. The MEU has a concern that the depreciation approach nominated by the TNSP has the potential to achieve one of two possible outcomes. Firstly, by front loading the depreciation, there is an outcome which requires current consumers to carry a larger proportion of the costs of an augmentation than the benefit they will receive. Equally, by back end loading depreciation, it is the next generation of consumers that will become liable for costs which should have been carried by consumers of today.

The MEU is concerned that the approach to depreciation can be a tool for increasing or decreasing the impact of costs today, on future users. It therefore suggests that the AER implement a comparative analysis of the depreciation process proposed by a TNSP to identify that there is no unjustifiable transfer of costs between current and future users.

In this regard MEU would suggest that the inflation rate is used as a the deflator of future costs.

2.3.2 Changing depreciation approaches between resets

The MEU is concerned that TNSPs might use different approaches to depreciation between regulatory resets. For example, at one reset the TNSP might elect to front end load the depreciation, yet at the next to back end load the depreciation rate. This will create potential for depreciation to be used as a manipulative tool to the possible detriment of consumers.

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[4] AER Electricity Transmission Network Service Providers Post-Tax Revenue Model EXPLANATORY STATEMENT AND ISSUES PAPER January 2007, page 4

The MEU considers that TNSPs be required to fix the approach to depreciation and not be permitted to vary the approach in later resets, unless the regulator considers that such would not be contrary to the interests of present and future users.

2.3.3 Timing

The second issue is whether depreciation commences at the point of first expenditure, when the asset is first tested or when the asset is available for use. The associated issue in regard to selecting the most appropriate point for depreciation, is whether the TNSP should be permitted to have a return on capital used for the development of the asset – usually this is referred to as a return on working capital.

The MEU would refer the AER to what actually occurs in a competitive environment. For example, a manufacturer or service provider would identify that an augmentation to its assets is required. Until that augmentation is actually producing saleable product, there is no return on the expenditure at all. In fact until the asset commences producing there is a net loss of funds by the business, with costs being incurred by the business for the borrowings made, and shareholders not getting a return on the equity funds provided. The assets which have been incorporated into the business asset base are considered to be sunk funds.

In the case of TNSPs, the equivalent to this example would be that the TNSP would not get a return on capital (ie the asset would not be rolled into the asset base) until it was operating as intended. Further, there would be no facility awarded by the regulator for the TNSP to receive any provision for a return on the working capital used by the TNSP as it implements the augmentation.

At previous times the TNSPs have stated that they should receive a return on funds as they are expended or to receive a return on the working capital needed to develop the new asset. Their argument refers to the long period they experience between the initial commitment of funds for an investment to the time of the asset providing the service intended.

The MEU would counter this argument by pointing out that many of the investments their members make take as long (if not longer) than the times indicated by the TNSPs. MEU member companies do not get any return (on assets or working capital) in developing any of their assets until the assets are producing product. There should not be any special treatment for TNSPs.

2.3 Regulatory control period

The MEU concurs that the Rules implicitly permit the TNSP to solely decide on the regulatory control period. This flexibility would create the need for the AER to build an absurdly large model for the roll forward approach for revenue setting.

The MEU agrees that a sensible approach is to build a model for the most commonly used regulatory period (this is five years) and to require a model for a "non-standard" regulatory period to be constructed from the basis of the "standard" model.

However, the AER should make it clear how it proposes to extend the model to accommodate different regulatory periods, and what assumptions and calculations will achieve a consistent outcome in the model for a "non-standard" regulatory period.

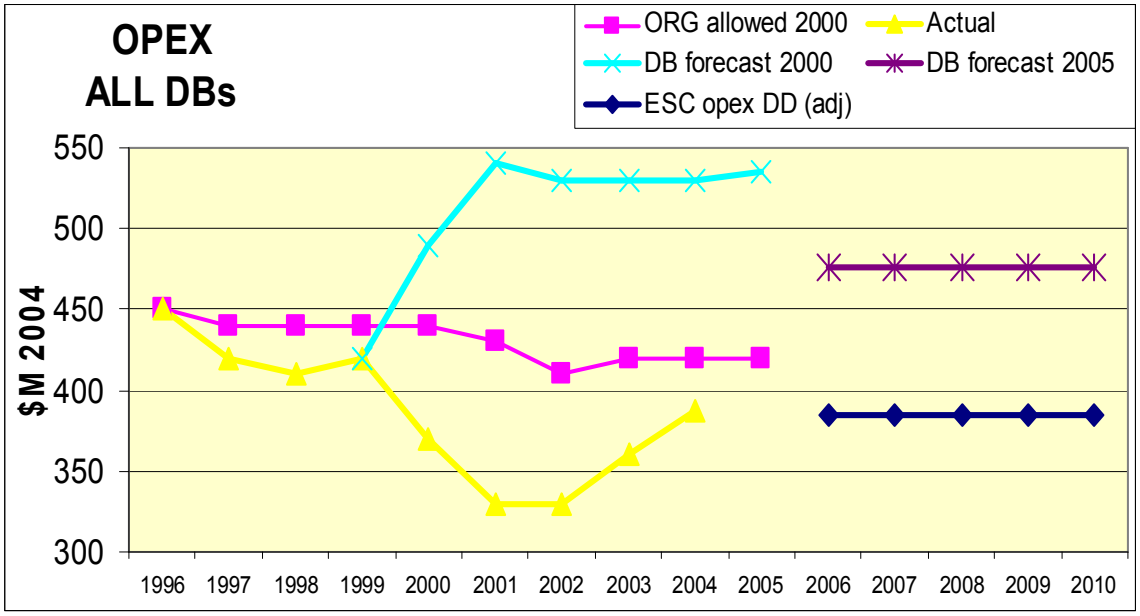
2.4 The impact of timing assumptions

The AER notes that there are effectively three elements of cash flow that impact the building block regulatory approachl. These are the cash flows for revenue, opex and capex.

Revenue – currently consumers pay for the use of TNSP assets on a monthly basis. The amount paid each month is based on the same inputs and varies only with the amount of power taken each month. Revenue raised is expected to match the annual revenue permitted by the regulator and is adjusted each year for any "unders and overs" incurred in the previous year.

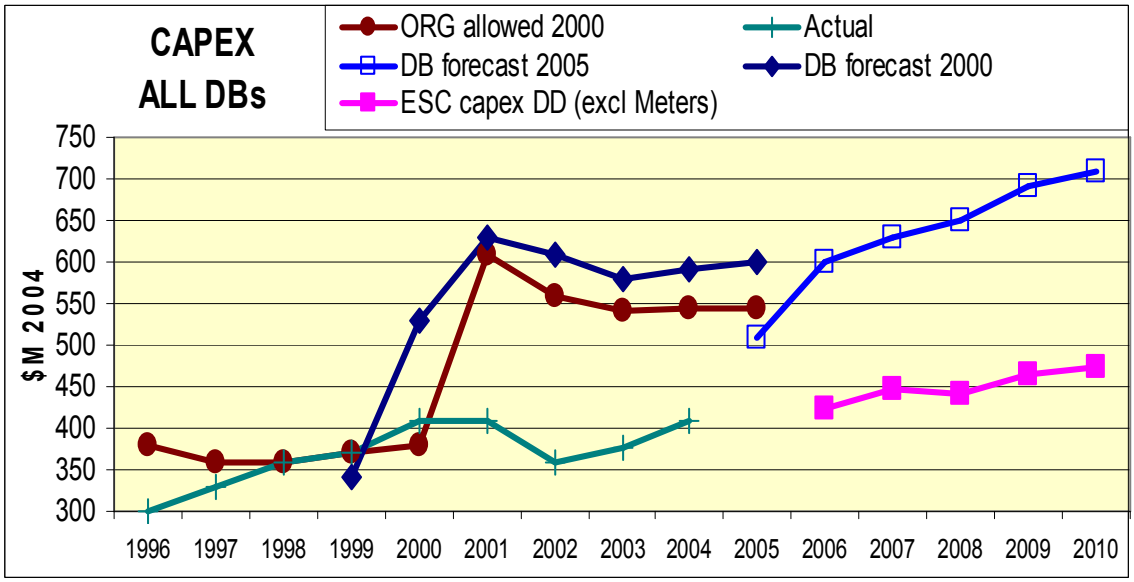
Opex – the TNSP is assumed to expend its opex on a consistent basis throughout a year and to reflect the amount of opex permitted by the regulator for each year. In fact it has been observed that opex tends to be underspent in early years and overspent in the latter years of a regulatory period.

To demonstrate this, the following charts show the opex claims and the actuals since 1995 for all the electricity distribution companies in Victoria. This clearly shows the way regulated businesses attempt to manipulate the regulatory environment.



Source: ESC Victoria

Capex – the TNSP is assumed to expend its capex on a consistent basis throughout a year and to reflect the amount of capex permitted by the regulator for each year. In fact, it has been observed that capex tends to be underspent in early years and overspent in the latter years of a regulatory period. The equivalent chart to the one on opex shows a similar approach.



Source: ESC Victoria

There is potential for regulated businesses to manipulate their opex and capex throughout the regulatory period in order to achieve three outcomes, viz

1. increased cash flow benefits from underspending in the early years,
2. maximizing the ability to recover "efficiency" benefits by implying the early years underspends were unsustainable, and
3. setting an expectation for the next reset by having large opex and capex amounts in the later years to set a new benchmark for the next regulatory period.

At the same time, TNSPs attempt to ensure that the revenue tends to be on the high side of permitted revenues, as this provides a cash flow benefit to the TNSP, despite there being an interest impact for any under/over recoveries.

Therefore the MEU has a concern that to take an approach which attempts to balance the impact of revenue, opex and capex is likely to disadvantage consumers, as the TNSPs will attempt to use any approach to their advantage.

In the absence of these manipulations it would appear reasonable that opex and revenue incurred in any one year be assumed to be annually coincident.

As the annual revenue and opex costs are not known until the end of a year, to assume that both occur at the end of the year appears reasonable. Yet if a cash flow analysis is carried out on this basis, because there are different amounts for revenue and opex (with opex being the smaller amount) then this approach might provide a bias in favour of the TNSP.

Further, provided that capex is only introduced when the asset is put into use, it would appear reasonable that the capex for assets put into use be assumed to occur halfway through the year.

The MEU has a concern that the approach suggested by the AER might entrench a bias in favour of the TNSPs. In order to assure that the AER approach is equitable, the MEU suggests that the AER carryout a quarterly cash flow analysis using quarterly CPI adjustments to demonstrate that their approach does not provide any bias detrimental to consumer interests.

3. The roll forward model

The MEU notes that this Issues Paper is identical to the one prepared for the Issues Paper relating to the Post Tax Revenue Model.

On this basis the MEU comments in the section above apply equally to its comments on the roll forward model.

3.1 Depreciation

In the development of the roll forward model it is noted that there is a potential for there to be a number of different approaches used to assess depreciation. Specifically:

- Assets must be depreciated using a profile reflecting the nature of the assets (Rule 6A.6.3(b)(2)
- Assets dedicated to a single user or group of single users (excluding DNSPs) valued at more than $20m must be depreciated under a straight line method (Rule 6A.6.3 (c)

This has the potential to result in a number of different depreciation schedules and depreciation durations being applied to the depreciation schedule.

Depreciation is a key element of the roll forward model and as such it must be transparent to all. Current processes used only advise the age of assets, the expected life of the assets being depreciated and that depreciation will be performed on a straight line approach over the economic life. The current approach is that the depreciation amount for each asset is set for each year and that this amount will be inflated by CPI each year to maintain that same “real” value included for depreciation.

As this is a relatively straight forward mathematical approach, it has been assumed that the regulator has calculated the depreciation amounts accurately, and so a simple one line outcome has been accepted within the regulatory determination.

With the ability of the TNSP to set its own depreciation schedules, this mathematical approach is no longer sensible let alone acceptable. If the TNSP elects to use a depreciation schedule different to the straight line approach, then there must be a detailed depreciation calculation carried out for each asset depreciated and for this to be provided on a transparent process for each asset and asset class. This is seen as essential as the

approach to depreciation has the ability to allow a TNSP to manipulate outcomes (such as is identified in spending opex and capex in section 2 above) to increase the cash flow benefit and profitability of the TNSP.

Whilst it is accepted that the AEMC has provided a high degree of prescription on the AER in relation to depreciation, and a high measure of flexibility to the TNSP as to their preferred approach to depreciation, this should not be permitted to provide a TNSP with enhanced outcomes at the expense of consumers. The AER's guideline should provide more detailed requirements to demonstrate what is changed and the impact of these changes sought by the TNSP.

4. Efficiency benefit sharing

The essential concept of the incentive regulatory regime used in Australia is that regulated businesses will identify ways and implement measures to reduce their costs, both in the need for capex and opex. The assumed principle is that that if a regulated business does identify cost savings then providing it gets a share of these savings it will pass the long term benefit onto consumers.

The reality is that if any business can identify savings and if it can find a way of retaining these savings in full, without sharing them with the customers by way of lower prices, then they will.

Competition provides a natural process by which businesses by default have to pass on the benefits of their savings in costs if they want to hold a defined share of the market – a business that is in competition will identify the costs that its competitors will be exposed to, and the amount of output possible by its competitors. It will compare these basic market approaches with the size of the market for the product involved. With this comparison, a business can match its costs and production with its targeted profit levels and identify what is the optimum market price which brings it closest to its corporate profit requirements.

For instance, a business might target a particular sector of the market where it can attain a high unit profit margin and forego the need to increase market share. Equally, a business with large production facilities will seek to maximise capacity (effectively increasing its opex and capex) chasing higher turnover with a lower margin in order to satisfy its shareholders.

To replicate such market pressures on a monopoly is essentially impossible, even with in a highly regulated environment. The fact that Australian regulators are required to apply a “light handed” regulatory approach, makes the challenge even harder than it need be.

To simplify presentation of the MEU concerns, we pose a series of questions:

1. Given a preference would a business seek to reduce its costs and retain these in perpetuity rather than have a share of the reductions for a short period of time?
2. Can a regulator know if there is a sustainable saving when told by the business that the saving is unsustainable, particularly if the saving disappears after a period of time?
3. Would a business try to convince a regulator that its need for more opex and capex has risen, even if they have not?
4. Would a regulated business balance the once off costs arising from a reduction in service performance against the potential of increased future

revenue by arguing that the regulator had reduced its allowances of opex and capex too far?

5. If the return on capital was so good that it exceeded investing in other forms of revenue generating options, would a business seek to increase its capex requirements, even if there was no need to?
6. Do the shareholders of a business seek to maximise their returns as the predominant goal, even if this might not be based on the long term viability of the business?

An associated question is why would a regulated business assess the cost of poor performance against the saving it might make in opex and capex reduction when it would carry the whole cost of poor performance but be required to share the savings resulting from the lower opex and capex that caused the reduced performance?

There is no doubt that the answer to the six questions is “yes”, and the answer to the associated question is that there would be little or no driver to do so.

In regard to point 6 above, it must be stressed that in the current investment climate, where there is a predominance of cash to invest by competing investment houses (a direct result of the burgeoning accumulation of long term funds held for superannuation purposes), the approach to investments has been to seek higher shorter term improvements in returns, at the expense of longer term holdings in businesses where short term earnings are lower but better over the long term.

Thus for a regulator to assess an incentive scheme for driving a regulated business to be more efficient in its use of capex and demand for opex, needs to be a holistic approach covering:

- return on capital,
- penalties for poor performance,
- an approach to assessing future opex and capex needs, and
- thinking like the business does, which is essentially to optimize the financial benefits for the shareholders in a shorter time frame than over the long term life that the assets have.

4.1 Incentive to manage capex

Fundamentally, there can be no incentive to manage capex. Investment is driven by returns.

The basic rule of investments is the return on the investment. If the return is better than a return from a different investment, then the funds will go to the investment with the better return. The only qualifier to this investment rule is that there should be a strategy to mange the investment so the impact of a down turn in the business can be ameliorated by diversity.

Thus a party seeking to invest will seek to maximise the return within the bounds of risk. The riskier an investment is, the greater need to diversify the portfolio of investments. Monopoly businesses are seen as 'low risk'. To have an asset which has a tied consumer base, providing a service that cannot be replicated, is considered a low risk investment. Electricity supply is an essential service, and the likelihood of demand for the service reducing is almost non-existent. Combine this with a guaranteed revenue stream, and the risk equates to investment in government bonds, which up until the mid 1990s, effectively was the risk profile for those businesses involved in the transport of electricity as they were universally, government owned businesses.

If the return of investment in the electricity transport assets is high, then investment will inevitably follow. The returns granted electricity transport assets are the same as the market average. This assessment is based on the development of the weighted average cost of capital (WACC) which provides for an equity beta of unity (the market average) and debt being sourced the same as that of a business rated as BBB+ or A, which are in the higher range of competitive businesses. This must be seen as a high rate of return when compared to the risk profile of electricity transport.

Certainly the investment market considers this is so as the performance of the Utilities Index on the ASX shows a distinct (and large) outperformance of shares in this sector (see chart in section 1 above). Appendix A confirms this trend.

A return on capex is provided as soon as the asset is put into service. An over run on capex is protected by the regulatory environment permitting the automatic roll in of capex incurred at the next regulatory review. Thus the risk on any capital investment providing its target return is very low.

Capital investment should increase the performance of the assets. Thus capital investment, besides being a low risk and a good return, has the potential to further increase the benefit of the investment by augmenting the return with a performance bonus. Investment in capital works is unlikely to reduce performance except in the short term while the works progress. Regulators are prepared to allow a reduction in performance during such times as the reason is eminently understandable. Unfortunately for competitive business, its customers are not so inclined and if performance falls, they are likely to go to other suppliers. No regulated monopoly business suffers from this competitive

pressure and so the consumers have to accept any performance reduction whilst capital works proceed.

Is there an incentive to reduce capital expenditure? Not really!

The incentives to minimise capex are few:

- If the business under-runs on capex, then it is permitted to retain the return on the capital not spent until the end of the regulatory period. This is an incentive to reduce the need for capex.
- A need for capital requires the business to seek more equity and debt to provide the capital.

Against this there are a number of incentives to maximise capex:

- If the WACC awarded exceeds the market expectations for the risk profile involved, then debt and equity will be readily sourced. As noted above the regulators do provide electricity transport businesses with a better risk/return than applies to the competitive market
- A lack of investment will cause a reduction in performance and penalties can result, whereas adequate or excessive capex can lead to performance bonuses.
- The regulated business is granted capex by the regulator, based on the requests of the business. As capex is readily sourced then there is a driver to overstate capex needs rather than understate the needs.
- If the capex is less than the businesses requires, but the capex is needed, the business will suffer the loss of the return for only a limited time (ie until the next reset) when it will automatically receive a return on the full investment amount for the life of the asset. Development of a typical cash flow analysis shows that the IRR of losing (say) two years of the return on an investment causes only a marginal reduction in the internal rate of return (IRR) for an investment. This identifies that the regulatory approach does not constitute a disincentive to over invest.

On balance, it is quite clear that the disincentives for investing capital are more than outweighed by the incentives to invest. It is accepted that the AEMC in its review of transmission revenue and pricing had this driver as a “top of mind” issue.

However, the impact of these on the regulatory incentive schemes has to be assessed in light of this imbalance in the total incentive environment.

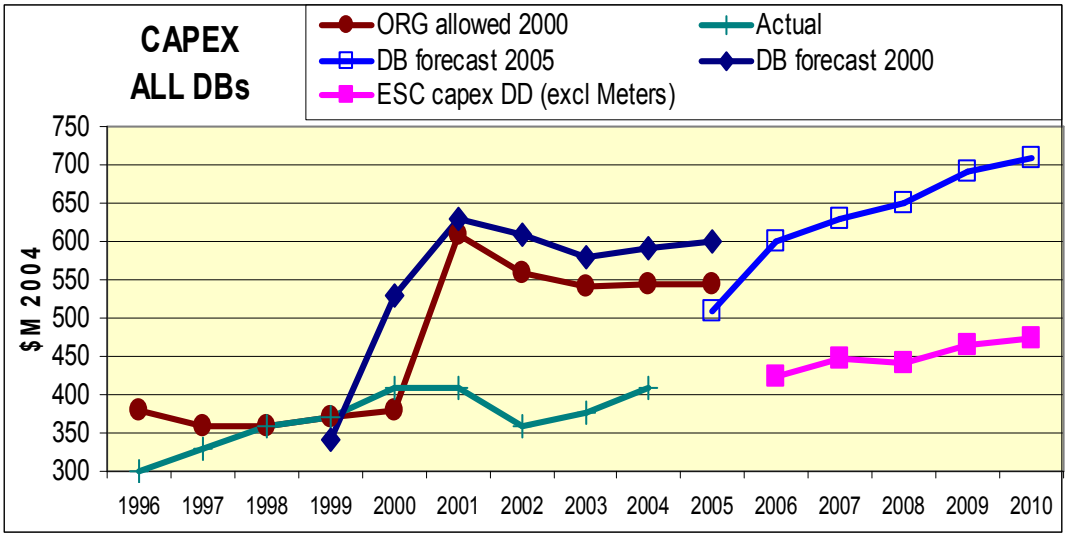
As implied by the AER approach, an incentive scheme for driving savings on capital investment has a very weak basis, basically caused by the decision to make the Rules so that capital investment is very attractive to the regulated business.

The incentive scheme suggested by the AER to encourage sensible investment and to drive costs down is predicated on the concept that a bonus arrangement for minimising capex will encourage the regulated business to diligently work to minimise capex in the interests of consumers. This would work in the absence of the overwhelming incentives for investment currently embedded in the Rules The benefits of the capex penalty/bonus arrangement proposed by the AER will pale into insignificance in light of the AEMC decisions to incentivise investment.

The MEU draws attention to the current gaming used by regulated businesses in capex. In section 2.4 there is a chart which shows the capex claims and actuals by the Victorian distribution businesses – businesses that operated under a regulatory scheme similar to that now in the Rules for transmission revenue.

This shows that the businesses “gamed” the regulator in 2000 by underspending in the early years of each regulatory period (ie years 1996/98 and 2002/03) and ramped up the expenditure in the later years to “justify” that more capex was needed in the next review (granted in 2001) and that the earlier savings were “unsustainable” to be carried forward into the latter years.

The Victorian example also shows the difficulty in benchmarking capex needs. In theory, under incentive regulation, benchmarking is intended to provide “competition by comparison” and so imply some degree of control over allowances for capex. In fact all networks have successfully convinced regulators that their network is unique and cannot be compared, as it the needs reflect differing levels of growth, age and population movements. In fact there is probably some basis for the claims of the network in relation to capex needs. Combined with the incentives granted for investment in the Rules, benchmarking of capex probably has even less validity in setting capex than before the changes were made.



Source: ESC Victoria

Before the 2005 review, the regulator had stated that it would use actual expenditure in 2004 as the basis for assessing forward needs. This encouraged the businesses to underspend in the early years to maximise the "unearned" return on capex not spent, and to increase usage in 2004 to justify increases for the next period.

It is salutary to note that the supposed difficulty in sourcing capex did not seem to be a driver on the businesses. Their request for capex for the 2006/10 period was an increase on the regulatory alloweds for previous capex although there was no expenditure of at this level despite capex at the high level being included in the revenue.

The outcome is that the regulator cut back the claimed capex allowances for 2006-2010, implying that consumers were gaining a benefit by the capex incentive program reduction.

The MEU considers that there is little in the incentive scheme proposed by the AER to encourage the business to seek to minimise capex and share the benefits with consumers. Further, the MEU sees that capex allowances are likely to be "gamed" by the businesses, effectively destroying the benefits of any incentive arrangements put in place.

The MEU has therefore come, albeit reluctantly, to the conclusion that any incentive scheme proposed for capex under the current regime is doomed to failure.

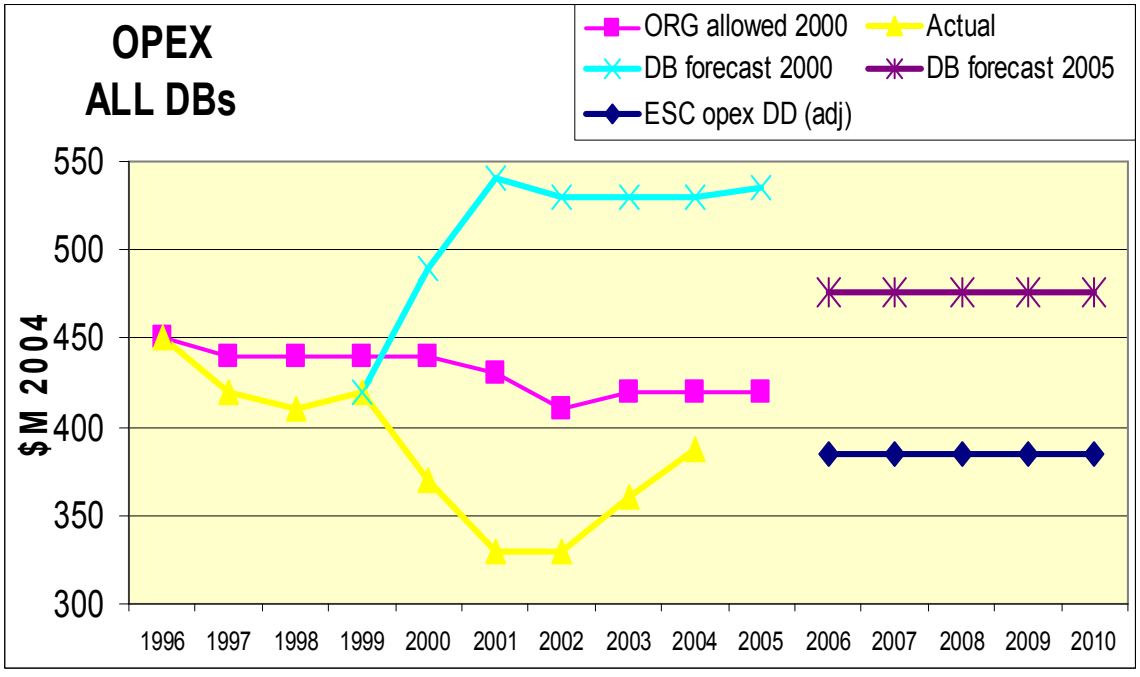
Having stated this, it is pointed out in section 4.3 that as opex and capex are intertwined, to allow capex to over run and so allow a maximum benefit for opex should not be supported. There is support for an incentive scheme for opex, but any opex benefit carried forward should be discounted for any capex over run ie where there would have been a negative carryover from a capex incentive program

4.2 Incentive to manage opex

Despite its negative views on incentives to manage capex, the MEU supports an incentive scheme to manage opex.

Under the building block approach, opex is intended to provide sufficient funds to cover the actual costs of operating the network, and no more. This implies that there are no inbuilt incentives in the Rules for opex, as there now exist for capex.

Notwithstanding this, there still exists the potential for gaming and in section 2.4 there is a chart showing the allowed and actual expenditure on operating which reproduced.



Source: ESC Victoria

This shows that the businesses "gamed" the regulator in 2000 by underspending in the early years of each regulatory period (ie years 1996/98 and 2002/03) and ramped up the expenditure in the later years to "justify" that more opex was

needed in the next review (granted in 2001) and that the earlier savings were "unsustainable" to be carried forward into the latter years.

As for capex, before the 2005 review, the regulator had stated that it would use actual expenditure in 2004 as the basis for assessing forward needs. This encouraged the businesses to underspend in the early years to maximise the "unearned" benefit of opex not spent, and to increase usage in 2004 to justify increases for the next period.

Despite this, the businesses claimed an increase in opex above the 2004 actuals. Unfortunately, as with capex, the businesses were able to convince the regulator that the early years of opex savings were unsustainable as the regulator permitted the new opex to be at 2004 levels.

The outcome is that the regulator cut back the claimed opex allowances for 2006-2010, implying that consumers were gaining a benefit by the incentive opex program reduction.

The opex incentive program was partly successful. The businesses retained all of the under spend in 2001/05, and had the opex reduced from the claimed level back to 2004 levels.

It is obvious that the businesses attempted to "game" the regulator and were partly successful to an extent. Certainly much of the early year under-runs were not passed through to consumers, but the benefit of the difference between allowed and actual in 2004 was passed onto consumers.

It is on this basis that MEU considers that there are valid reasons to support an incentive scheme for opex.

4.3 Limits on incentive schemes

Given its support for an incentive scheme on opex, the MEU would state that the following controls must apply to such a scheme:

1. The basis for setting opex must not be a single year, as this encourages the "gaming" process. The average for the previous five years of opex, adjusted for clearly identified step changes in laws and rules developed by third parties entitled to make such changes should be the basis for the forward opex. These changes should included both increases and decreases
2. There is no logic to support a penalty being carried forward. Whilst the principle of equality between penalty and bonus has an initial attraction, it

makes little sense to reduce opex in the next period below the amount already identified as being needed. A reduction in opex has the potential to disadvantage consumers by more than the saving that might result from carrying forward the penalty into the next period. This asymmetry is accepted as a pragmatic approach rather than one which is based on theory and equality.

3. If there is a large carryover of an incentive into the next period (as for example seen in the Victorian review), then this highlights that the regulator has not done its job properly in the previous reset. The expectation is that there should only be marginal changes in opex between actuals and allowed.
4. If there is a large benefit to be carried forward then the regulator should use its discretion and deny the carry forward, as it would be a clear case of the business "gaming" the regulator and there must be no rewards for "gaming". The fact that the business is permitted to retain the under-run during the period is unacceptable but, again, pragmatism supports this decision.
5. There is a close correlation between opex and capex, with the cause of most capex being offset by a reduction in opex. Thus to permit a carry forward of the incentive for one, whilst the other has seen an over run which does not incur a penalty, effectively denies the synergies between the two. To address the asymmetry between a bonus being carried forward but no penalty being carried forward, the amount carried forward should be the net benefit (ie the bonus less the penalty) only.

4.4 Other regulatory issues

4.4.1 It is accepted that the most common (so far) regulatory period is 5 years. If there are other regulatory periods introduced then care needs to be made of any incentive schemes.

If there is a longer period (eg 10 years) this has the potential for the consumer to be significantly disadvantaged, particularly if the regulator has over provided for opex. A 10 year period of over provision will require consumers to pay excessively for an error by the regulator. Equally to carry forward the benefit of a saving for 10 years is probably over kill.

The MEU suggests that a regulatory incentive scheme should be assessed each five years (or part thereof) regardless of the duration of the reset. An incentive should only be carried forward for a five year period

4.4.2 An incentive scheme should only provide a reward for actions within the control of the business. It is unreasonable for consumers to pay a

business for windfall wins, or to penalize the business for matters outside its reasonable control. Thus the scheme must be targeted on what the business does to reduce costs to consumers.

On the issue of pass through amounts, the MEU does not believe that these should be included in the incentive, **except** where such a pass through (eg a cost which increases opex such as network support) has resulted in a reduction elsewhere (eg a reduction in capex due to the deferral or elimination of capital works). If the increase in (say) opex results in a greater reduction of capex, then the business should be incentivised to seek the lowest cost option for consumers.

5. Service target incentive

The electricity network is purely a tool for delivering power – it is a form of transport. Other than providing this connection between generator and consumer, it adds little as far as value to the electricity supply system. Yet in performing its function, it can have a massive impact on consumers and generators.

The MEU supported the move by the AEMC in having the transmission incentive scheme increasing from 1% of revenue at risk to having up to 5% of revenue subject to the service performance incentive scheme. It was felt that this increase was warranted to provide a valuable element to encourage better performance of the TNSPs.

When considering a service performance incentive scheme there are two elements that must be considered:

- What are the key elements of service performance that will add value to those offering the incentive for better performance. As consumers are the beneficiaries of the improved service and will pay the incentive, there must be a focus on what consumers seek from the TNSPs as an improved service.
- Should the incentive be one way (ie a bonus only) or two way (a penalty if the targets are not met, combined with a bonus if they are exceeded).
- The amount at risk.

The amount at risk
The MEU notes that the AER has elected to set the maximum exposure of the TNSP to the incentive scheme to be 1%, as the AER considers that in an untried system, this conservatism is warranted. **The MEU disagrees with this decision.**

Firstly TNSPs have now been regulated for at least one cycle and most have (or will be shortly) been exposed to a second review. Whilst the AER can point to the fact that it has not previously regulated the TNSPs, the ACCC has done so. In these ACCC reviews, a performance incentive scheme was an element of that review. On this basis there is an understanding by the TNSPs of what an incentive scheme requires, and the potential for the TNSP to win or lose under such a scheme.

The AEMC increased the amount at risk for a sound reason – to encourage better performance by the TNSP as part of the overall

revised TNSP regulatory regime. The AER has unilaterally countered this part of the regulatory package.

However the Rules are explicit – it is the TNSP that selects the amount of revenue to be at risk, and not the AER. The AER has the power to decide if a TNSP proposal does not comply with the Rules.

If the AER wishes to be conservative, it might suggest that as a starting point, the TNSP has the right to select its own limit of revenue at risk, but capping this for the first reset after the current period, at 3% of revenue[5]. At the following review, the 5% limit should be set.

Bonus or Penalty/bonus
The MEU considers that an incentive must be two way, with the targets seek at an achievable level, but requiring additional effort for them to be exceeded. An incentive scheme that readily provides rewards is not an incentive scheme but one which gives money away.

The incentive scheme must be two way so that there is an incentive to achieve the targets as a matter of course, and the only way to provide an incentive for this is by imposing a penalty for non-achievement. Out-performance is rewarded by the payment of a bonus.

Performance targets
The Rules clause 6A.7.4(b) states

"The principles are that the *service target performance incentive scheme* should:

(1) provide incentives for each *Transmission Network Service Provider* to:

(i) provide greater *reliability* of the *transmission system* that is owned, controlled or operated by it at all times when *Transmission Network Users* place greatest value on the *reliability* of the *transmission system*; and
(ii) improve and maintain the *reliability* of those elements of the *transmission system* that are most important to determining *spot prices*;"

The MEU considers that this provides a very good statement of what users of the transmission system do seek, be they generators or consumers.

[5] 3% is halfway between 1% and 5%

The AER suggests that the following performance measures should be the basis for the scheme

- transmission circuit availability
- loss of supply event frequency
- average outage duration

Additionally it seeks a definition for a

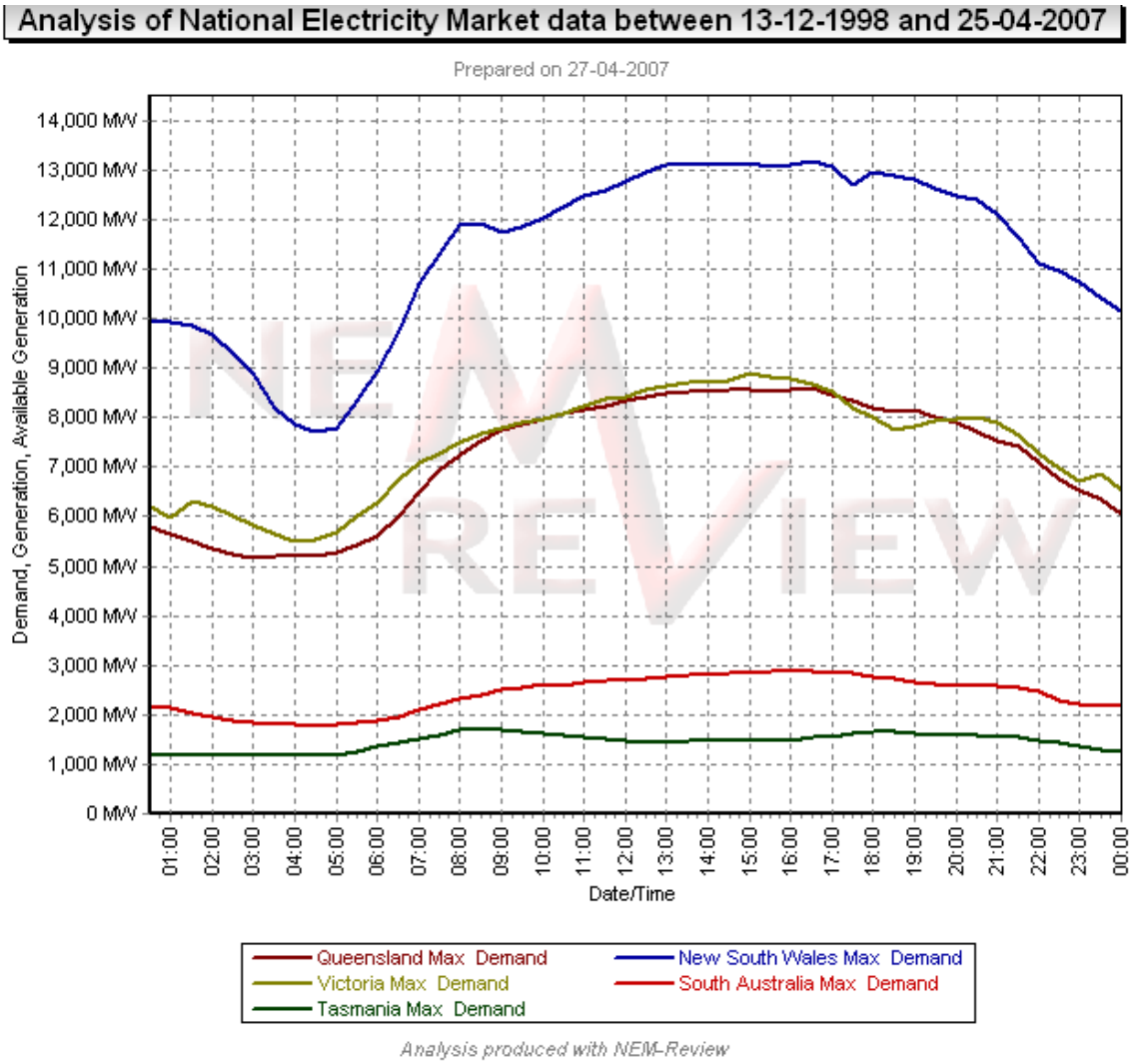
> "system minutes" in the loss of supply event frequency parameter

It is noted that none of the proposed measures relate to service performance which measures availability of the network when it will deliver the greatest benefit to users, nor is there any reference to availability when determining spot prices.

What is required is a measure which reflects value to users. As a start the MEU suggests that there must be a review of previous performance and demand on the networks at times of greatest demand and times of the highest regional spot prices.

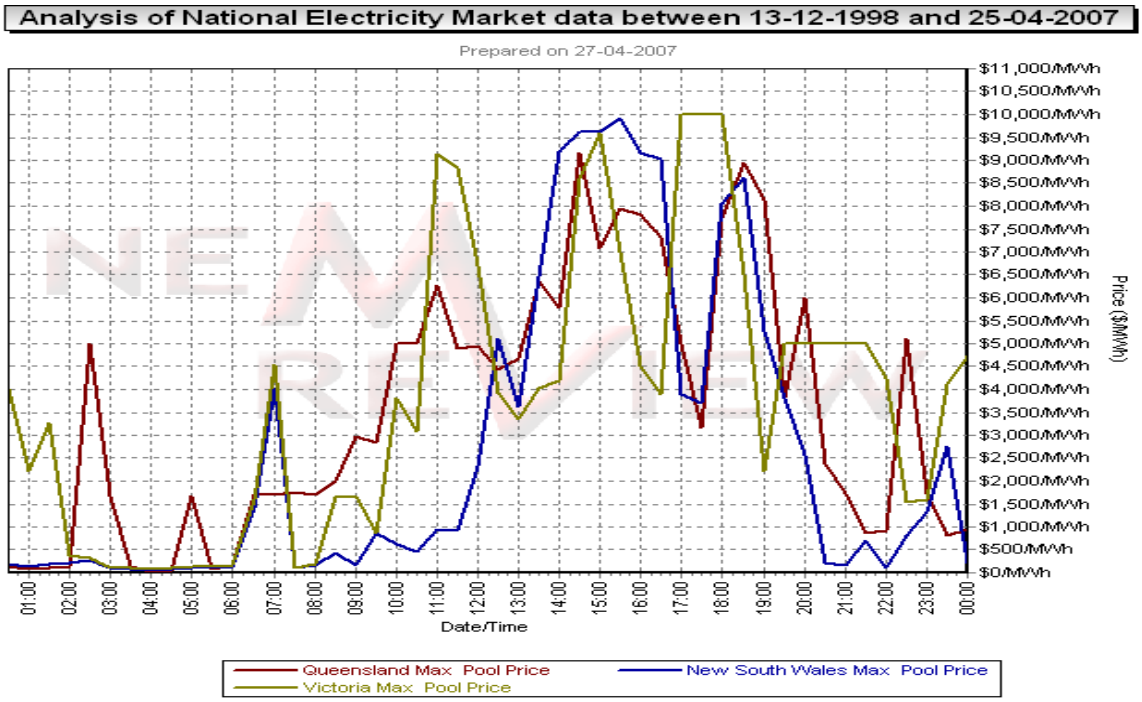
The simplest analysis of demand shows that generators and consumers are most active in the afternoons. The following chart shows the maximum demand in each NEM region averaged by time of day, since the start of the NEM.

This shows that nominally users of the transmission system would require the transmission system to be available between noon and 6 pm on week days. This provides the start of process to develop a measure which reflects the needs of users



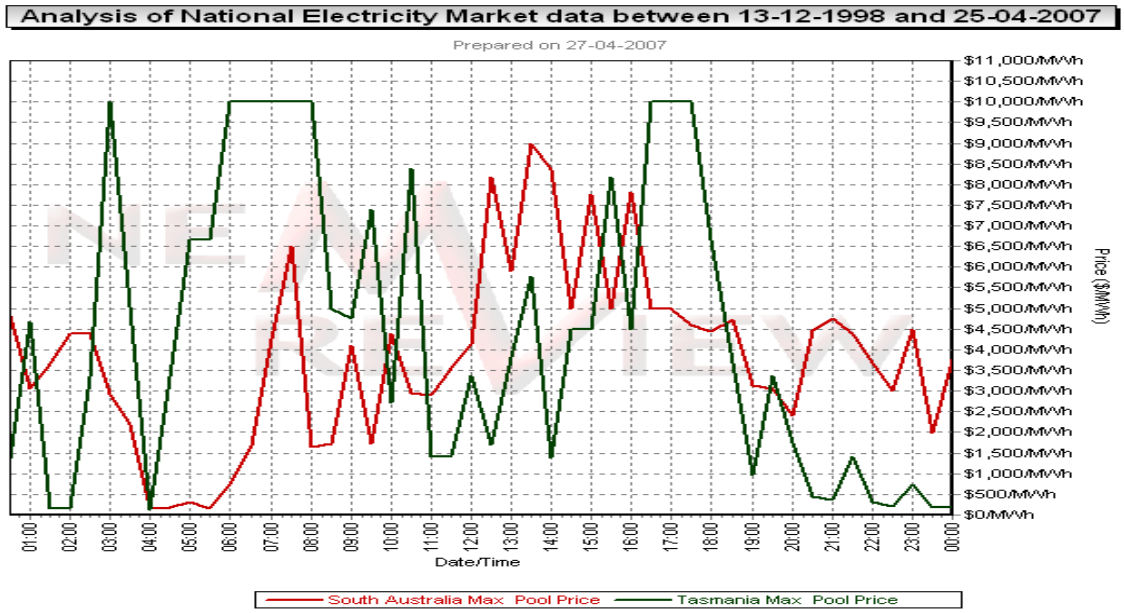
Source: NEMMCo and NEM Review

Analysis of highest spot prices related to time of day shows a similar trend for Queensland, NSW and Victoria, with the bulk of high spot prices occurring in the similar range of 10 am to 8 pm, although there are distinct periods outside this period showing a lesser correlation between time and prices.



Source: NEMMCo and NEM Review

This correlation does not hold for SA or Tasmania.



Source: NEMMCo and NEM Review

However, such an analysis (but with more depth) is needed to develop a set of targets which have value to users of the networks.

In addition to time off supply is the frequency of outages or voltage changes of sufficient magnitude to cause failure of supply to consumers or from generators which might last only seconds, yet cause the users to trip off supply as a result of the disturbance. Thus frequency of disturbances which cause the user to disconnect is an important indicator of performance. Examples of such disturbances are when the TNSP might have failed to wash insulators and arcing occurs, causing generator and/or consumer protection to go off supply. Although the TNSP might only be off supply for a short time, the impact can cause hours of lost production for the generator and consumer.

Thus MEU would suggest that frequency of loss of supply (even for a second) should be measured.

Weightings

It is expected that there will be a number of performance targets set, and so there must be a method for allocating the weighting of each performance target. Those with the greatest weighting must be those that achieve the basic goal espoused in the Rules.

Conclusions

The MEU considers that the AER has not carried out sufficient investigation into identifying what service parameters mean most to consumers, nor has it identified those parameters which will provide the most impact in relation to spot prices.

6. Proposal and information provision

The MEU has noted that it is the provision of information that creates the ability of the network owner to "game" the regulator. Network operators can provide too much information which has little value and too little of the information which is critical to competent regulation. Combining this ability with the network operator declaring certain information to be confidential adds to the asymmetry of power over the regulatory process.

Jurisdictional regulators (especially those with multiple businesses of the same type) have had to develop pro forma reporting structures which allow the ready comparison of information from different sources. The MEU considers that this approach has much to support it.

The concept of quality assurance throughout industry is now a well recognised approach to ensuring compliance with standards set either internally or by external bodies. The MEU recommends that it requires the regulated businesses to comply with a quality assurance approach to ensuring that the data it collects and provides to the regulator ahs been collected and recorded appropriately. Such an approach requires the business to prove to an independent monitoring authority that it has complied with its standards.

The MEU considers that the AER has identified the bulk of the information that should be provided with the TNSP proposal. There are four additional aspects of information provision that the MEU considers need to be added to the guidelines.

Historic capex and opex
The AER has determined that it requires historic opex and capex for the previous three years and for the forecast opex and capex for the last two years of the regulatory period.

The MEU considers that this is insufficient.

When the previous review was undertaken, the opex and capex for the last two years would be estimated. At least five years of actual capex and opex is needed to provide a sound basis on which to compare performance and forecast expenditure. Although it is possible for previous expenditure to be collated from the regulatory decisions of earlier periods, it is suggested that as the MEU affiliate EUCV did on its on behalf for the case of the Victorian distribution review, the AER require the TNSP to provide ten years of actual capex and opex together with the amounts

included in the regulatory decisions. This provides a strong indication of the expenditure performance of the TNSP over a longer period.

Further the MEU suggests that the average of the previous five years of actual capex and opex be used as the basis for establishing a start point for future capex and opex. This start point would need to be adjusted for step changes and for changes in demand. Notwithstanding these changes, historic performance and needs provides a soundly based estimate to compare the financial performance of the TNSP.

Step changes

As part of the provision and explanation of the new capex and opex needs, the TNSP should provide a list of each step change that has occurred since the previous review and which has led to a change in the amounts of capex and opex required.

These step changes should reflect both increases and decreases and the costs related to each needs to be detailed.

The provision of step changes gives the AER a better understanding of why there might be changes in the needs of capex and opex, and the impact of the step changes will have had on historic opex and capex.

Competition by comparison

An essential element of incentive regulation is to apply performance pressure on the regulated business by comparing its opex and capex performance to similar businesses.

A minimum of five years average actual expenditure is considered necessary to provide a baseline of historic expenditure. As detailed in sections 4.1 and 4.2 above, a regulated business is incentivised to “game” the regulator by underspending in the early years of a regulatory period and overspending in the later years. Also as can be seen from the charts provided in those sections, the regulated businesses mis-forecast the expected expenditure for the last year of the period by over 40% and did so with impunity. By using the last years of the previous period rather than the forecasts for last years of the current period provides an incentive for the business to forecast more accurately.

By the provision of 10 years of actual and allowed opex and capex (adjusted by step changes) this provides a strong basis for assessing the historic performance of the TNSP with its claimed forecast expenditure. When this data is compared with comparable data of other similar businesses, it gives a sound basis for assessment of the claims.

The MEU notes that there is no requirement in the guidelines on the TNSP to provide any comparative performance data. Clauses 6A.6.6(e)(4) and 6A.6.7(e)(4) require there to be benchmark performance comparisons for capex and opex. This requirement must be added.

Indicative Prices

Both generators and users, whilst interested in the total revenue permitted to the TNSP, have a greater interest in the prices for the services that they see will be the outcome of the review. The outcome is the prices that will be applied to each class of user of the network.

It is noted that the TNSP is to provide as part of the proposal the costs that will be allocated to each of the five main elements of the TNSP cost structure of the prescribed services viz entry services, exit services, common services, TUoS and general services. With the provision of these cost allocations already a requirement of the proposal, it will take little for the TNSP to provide an indicative price schedule based on its proposal.

The provision of an indicative price schedule will provide those who ultimately pay the costs of the TNSP an indication as to their share of the total revenue.

7. Cost allocation

It is noted that the cost allocation included in these guidelines is to allocate the TNSP costs between prescribed services (which may include multiple prescribed services), negotiated services and other services provided by the TNSP. The detail of cost allocation for prescribed services is to be provided under another guideline.

Consumers pay in excess of 90% of all the revenue granted a TNSP by the regulator. Therefore there is great concern that the TNSP does not indirectly pay for costs which are being recovered by the TNSP under its other prescribed services, negotiated services or other service provision.

The issue of ring fencing between different services provided by regulated entities has been a major one which has produced considerable concern to consumers since the advent of deregulation. The incentive on a regulated business to cover some of its costs for activities external to the service under review is great, as it has the potential for the regulated business to

- undercut competitors and increase market share,
- increase profitability in an unregulated sector through support from the regulated element of the business
- cross subsidising between services offered, as the user of one service (even though regulated) might not be a user of another regulated service
- overstate the costs for the regulated business through inaccurate transfer pricing approaches.

In principle consumers do not object to a network service provider using its assets in a way that maximizes their utilisation, even if the purpose is unrelated to the regulated service provision. What does concern consumers is that assets which they effectively underwrite should not be used for other purposes unless they get some benefit from this occurring.

The Issues paper provides a good explanation of what the concerns are relating to ring fencing between separate activities of the TNSP and specifically raises a number of questions in relation to the approach taken to the guideline on cost allocation.

Verification of costs allocated as required

The MEU considers that overall the AER guideline on cost allocations between different services has been well addressed and provides a high level approach to what is the required outcome for cost allocations.

Notwithstanding this support for the guideline, there remains one major concern for consumers. Once the Rules for cost allocation have been stated and agreed between the AER and the TNSP, there requires a verification process to be instituted to verify that the agreed process has been used in the actual allocations.

The AER should establish an audit process (perhaps based on the principles of quality assurance) to verify that costs have been allocated appropriately.

Responses to AER questions

In responding to the questions raised in the issues paper, the MEU is cognizant that there is a wide variety of different TNSP corporate structures operating, ranging from government owned TNSPs (eg Powerlink, TransGrid, Transend), through part government owned (eg ElectraNet which is part owned by Powerlink), government owned TNSPs with distribution (eg EnergyAustralia, Western Power), privately owned TNSPs (eg APA) and privately owned TNSPs with distribution (eg SP Ausnet). Additionally some of these businesses have unregulated activities as part of their operations.

To provide a “one size fits all approach to cost allocation will be extremely challenging.

Q1. Are the working assumptions used to prepare this Issues Paper appropriate?

The MEU considers that the AER approach and assumptions are appropriate and should lead to an acceptable outcome for ringfencing between different activities of the TNSP and its parent.

Q2. Would it be appropriate to apply a single set of allocators to all network service providers?

The MEU recognises that different businesses will have different needs and that cost allocation methodologies could vary between businesses. This does not

mean that high level allocation requirements might not be the same but having different outcomes based on each unique business.

For example, corporate support for a conglomerate can be readily allocated on a number of different bases – turnover, profitability, numbers of staff, asset value. In fact corporate support is more often biased towards new business development and business elements in trouble, rather than managing existing and established elements of the business.

Thus the cost allocator for corporate support should not be necessarily based on one of the more obvious allocators but on a technique which better accommodates the reality of how corporate management time is used.

Implicitly MEU recognises that to apply a single set of cost allocators might not be effective, but equally extreme care needs to be taken to ensure that inappropriate allocations are not made, unreasonably loading costs into regulated services.

Q3. Should the regulated business or the AER select the allocators for shared costs?

Due to the differences between each business, the MEU recognises that the AER might not be the appropriate body to set the cost allocations. Equally the businesses have a vested interest in allocating costs into the prescribed revenue.

The MEU suggests that the TNSP be required to identify as part of its proposal how it intends to allocate costs between different elements of its business, and to seek approval of these.

The AER should provide Interested Parties with this information in order to seek feedback on the proposal, as many of the respondents have extensive management experience and knowledge of cost allocation approaches. This allows the AER to benefit from the experiences of others external to the TNSP in ensuring the cost allocation approach meets the requirements of the NER.

Q4. Is there merit in the regulated businesses working together to produce an "industry standard" for the attribution and allocation of costs?

As noted above the MEU is not convinced that there can be a "one size fits all" approach to cost allocation. Whilst it does not deny there might be an acceptable approach, the MEU is concerned that the resultant might well provide a loose approximation only resulting in a lowest common approach which for outlying businesses would result in considerable error.

Q5. Should cost allocation be allowed using the avoidable cost method and, if so, should it only be allowed for immaterial costs?

An avoided cost approach is inherently biased towards the largest business element carrying the bulk of the shared costs, and provides emerging business elements with a “free ride”.

The avoided cost approach would recognise that for example a person who dedicated 60% of his time to the transmission business, and 20% to each of two smaller business elements would be wholly allocated to the core transmission business, as there is no “half person”.

Bearing this in mind the MEU does not believe that the established business (ie the provision of the transmission service) should be required to subsidize the non regulated businesses in any way. In the case of sharing a person between two regulated businesses, this issue creates perhaps less concern, yet as a matter of principle, why should a consumer only using one of the two regulated services be required to subsidize other consumers.

If the costs are immaterial then common sense should prevail. But to implement this approach requires a definition as to what is classed as immaterial in the context of the TNSP proposal.

Q6. Is it appropriate that the scope of the regulatory audit (as it relates to cost allocation) only assess whether costs have been appropriately attributed or allocated, not whether the allocators themselves are most suitable?

It is a fundamental practice of quality assurance that an audit should only assess whether the processes have been followed, and not to comment on the content of the processes.

This means that audit should only comment on whether the costs have been allocated as required by the process, and not on the allocators themselves.

Equally audit would be failing in its duty if it noted that the description of the process predicted one outcome but the practice of the process resulted in a totally different outcome.

Appendix A

Data sourced from Commonwealth Securities Web site							
	Beta			Sector div yield			sector gearing D/E %
	27/2/06	23/8/06	30/1/07	27/2/06	23/8/06	30/1/07	
All ords	**1.08**	**1.04**	**1.02**	**4.3**	**4.3**	**3**	**36**
Consumer discretionary							
Automobiles and components	1.02	0.86	1.45	6.2	6.2	0.8	
consumer durables and apparel	1.75	1.39	1.42	5.3	5.2	5.3	44
consumer services	0.93	1.19	0.96	4.3	3.9	3.3	38
Media	1.51	1.39	1.03	4.5	4.4	3.9	21
Retailing	1.18	0.99	0.98	4.6	4.7	3.2	32
Consumer staples							
Food and drug retailing	0.62	0.64	0.64	3.8	3	3	75
Food beverage and tobacco	0.58	0.51	0.6	4.3	3.9	3.1	46
Energy	**0.96**	**1.04**	**1.21**	**3**	**2.8**	**2.8**	
Energy Equipment and services							
Oil and Gas							
Financials ex property							
Banks	0.86	0.68	0.82	4.3	4.1	4.4	
Diversified financials - resources	1.19	1.16	1.17	3.5	3.7	3.6	
Diversified financials - holdings	1.19	1.16		3.5	3.7		
Insurance	1.58	1.54	1.44	4.2	4	3	
Property Trusts	**1**	**1.04**	**1**	**6.9**	**6.9**	**3.8**	
Investment trusts management and development							
Health Care							
Equipment and services	1.19	1.09	1.01	2.8	3	2.7	7.2

Pharma & Biotech	1.81	1.52	1.01	2.3	2.9	2.7	7.2
	Beta			**Sector div yield**			**sector gearing**
	27/2/06	23/8/06	30/1/07	27/2/06	23/8/06	30/1/07	**D/E %**
Industrials							
Capital goods	1.11	1.12	1.04	4	4.1	3.6	34
Commercial services and supplies	1.11	1.19	1.27	4	3.9	3.4	28
Transportation	0.9	0.99	0.96	4.7	4.9	3.4	40
Info Tech							
Software and services	1.82	1.61	1.34	4.6	4.6	3.4	54
hardware and equipment	1.15	1.02	0.89	4.4	3.9	2.7	0.7
Semicondictors	1.15	1.02	0.89	0	0	0	58
Materials	**1.39**	**1.15**	**1.22**	**3.1**	**3.2**	**3.1**	
Chemicals							
Construction materials							
Containers and packaging							
Aluminium							
Diversified metals and mining							
Gold							
Precious metals and minerals							
Steel							
paper and forest products							
Telecomms	**0.44**	**0.29**	**0.37**	**5.7**	**6.2**	**3**	**15**
Diversified							
Wireless							
Utilities	**0.31**	**0.23**	**0.37**	**5.2**	**5**	**4.1**	**102**
Electric							
gas							
Multi							
Unclassified	**1**	**0.98**		**6.9**	**6.9**		