Major Energy Users Incorporated
73 Longview Road North Balwyn Vic 3104
Ph: (03) 9859 9138, Fx: (03) 9859 2301, Email: davidheadberry@bigpond.com

ENERGY USERS COALITION OF VICTORIA

73 Longview Road
North Balwyn, Vic, 3104
Ph: 0417 397 056
Email:davidheadberry@bigpond.com

Energy Markets Reform Forum
92 Pitt Street, Sydney, NSW 2000
Tel: (02) 9221 1185
Fax: (02) 9221 1101

ENERGY CONSUMERS COALITION OF SA

c/- John Pike, Seeley International
PO Box 140
Melrose Park, SA 5039
Ph: 0416 222 682
Email:davidheadberry@bigpond.com

21 October 2005

Mr Sebastian Roberts
General Manager
Transition Group
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Sir

MEU Inc Response to Regulatory Accounting Methodologies Position Paper

Attached is the Major Energy Users Inc response to the above referenced Position Paper.

Major Energy Users Inc is the umbrella body for expressing the views of the Energy Markets Forum (NSW), Energy Consumers Coalition of SA and Energy Users Coalition of Victoria when addressing national issues which would impact on each of these regional groups of energy consumers.

Yours sincerely

Mark Gell
Chair, Major Energy Users Inc

MAJOR ENERGY USERS Inc

On behalf of

ENERGY MARKETS REFORM FORUM,

ENERGY CONSUMERS COALITION OF SA,

ENERGY USERS COALITION OF VICTORIA

COMMENTS

ON THE

REGULATORY ACCOUNTING METHODOLOGIES
Position Paper

A SUBMISSION TO

AUSTRALIAN ENERGY REGULATOR

October 2005

The views expressed herein are those of the Major Energy Users Inc on behalf of the Energy Markets Reform Forum, the Electricity Consumers Coalition of South Australia and the Energy Users Coalition of Victoria.

Assistance in preparing the submission was provided by Headberry Partners Pty Ltd and Bob Lim & Co Pty Ltd.

INTRODUCTION

The MEU Inc interest in this AER review

This submission has been prepared by the Major Energy Users Inc (MEU) which represents the combined views of the Energy Markets Reform Forum, the Energy Consumers Coalition of SA and the Energy Users Coalition of Victoria. The MEU organization represents the larger users of electricity in the states of NSW, Victoria and SA, currently representing some 30% of the electricity used in SA and NSW, with only a slightly lesser proportion in Victoria.

The MEU includes such companies as OneSteel, BHP Billiton, Visy Paper, AMCOR, Orica, Seeley International, Tomago Aluminium, BlueScope Steel, Kimberly-Clark, Mitsubishi Motors, Holden, Toyota, Adelaide Brighton Cement, Ford, Air International, Unidrive and Zinifex (formerly Pasminco). As the members of the three groups also have a significant number of suppliers, as well as operations in other States (including Tasmania and Queensland), they therefore require that the actions taken by the MEU and the groups individually should provide support to their suppliers and related operations.

Further it should be noted that each of the companies comprising the individual groups and MEU, are employers of large numbers (in total, measured in 10,000s) of residential consumers of electricity and gas. As it is in the interests of each of the member companies to support their employees (particularly those members located in regional centres where each company is the dominant employer, such as Ford in Geelong, OneSteel in Whyalla and Newcastle, BlueScope Steel in Wollongong and Hastings, Zinifex in Port Pirie, Kimberly Clark in Mount Gambier and Holden in Elizabeth) the three groups and MEU can also lay claim to indirectly representing the interests of large numbers of residential consumers as well.

The companies in the group (and their suppliers) have identified that they have an interest in this AER review as the **cost** of the distribution networks services comprises the largest cost element in their electricity bills.

Electricity is now the main source of energy required by each MEU member in order to maintain their operations. A failure of supply of electricity effectively shuts down any business operating, and MEU members are no different. Thus the **reliable supply** of electricity is an essential element of each member's business.

With the introduction of highly sensitive equipment required to maintain operations at the highest level of productivity, the **quality** of electricity supplies is becoming increasingly important. The variation of voltage and introduction of harmonics by even small amounts now has the ability to shut down critical elements of many production processes. Thus MEU members have become increasingly more dependent on the quality of electricity supplies.

Each of the businesses represented by MEU has invested considerable capital in establishing their operations and in order that they can recover the capital costs invested, long-term **availability** of electricity supplies is required. If reliable supplies

of electricity are not available into the future the investments made by each business will have little value.

It is therefore essential that AER addresses the issues which impact on the cost, reliability, quality and the long term availability of electricity supplies to industry.

The AER review

The AER invited submissions from interest parties addressing the AER's Position Paper relating to the regulatory accounting methodologies which might be used.

The AER has reached some preliminary conclusions:-

1. The AER's preliminary view is that the "as-commissioned" approach is not consistent with the ex-ante incentive regime established in the AER's SRP. Specifically, it requires a project specific assessment and will require complex adjustments to ensure that the present value of the revenue stream over the life of the asset would be the same as under the "as-incurred" approach.

2. The AER's preliminary view is that under the "as-commissioned" approach an ex-post assessment would need to be undertaken. The assessment would need to consider the prudency of expenditure undertaken during the previous regulatory period on projects that are commissioned in the current regulatory period.

3. The AER's preliminary view is that the "as commissioned" approach would involve additional administrative complexity. This would affect TNSPs as well as the AER. TNSPs would be required to implement new arrangements and provide supporting on-going reporting.

4. The presentation of regulatory accounts differs from financial accounts. This applies whether or not the "as incurred" or "as commissioned" approach is applied. The AER's preliminary view is that the different reporting and reconciliation requirements do not favour one approach over the other. However, the AER recognises that TNSPs may incur one-off costs in the transition from one approach to another and that TNSPs should be compensated for any additional costs.

5. The AER's preliminary view is that consistency between accounting approaches across TNSPs would assist in comparing performance between TNSPs and over time.

6. The AER's preliminary view is that any price shocks associated with transitioning from the "as-commissioned" to the "as-incurred" approach is not likely to be significant.
7. The AER's preliminary view is that any price shocks associated with implementing either approach is not likely to be significant.

The AER then poses the following questions and requests comment on any other relevant matters:-

- Has the AER identified the appropriate issues? Are there other relevant matters that the AER should consider?
- Is the "as-commissioned" approach consistent with the ex-ante incentive regime established by the AER's SRP? How could the "as-commissioned" approach be applied to be consistent with the ex-ante incentive framework in the SRP?
- Given the issues raised in the second point, would the implementation of an "as-commissioned" approach be more administratively complex than the "as-incurred" approach? If so how material is the additional administrative complexity?
- Some TNSPs currently apply the "as-incurred" approach and some the "as-commissioned" approach. Are there costs in moving from one approach to the other? How material are they?
- If a TNSP changes its approach it may need to modify its regulatory accounts. Does this raise any accounting standards, auditing or other accounting issues?
- Has the AER appropriately weighed up the relevant issues in reaching its preliminary position?

THE MEU VIEWS RELATING TO THE ISSUE

The issue

The purpose of accounting is to keep track of a business' financial position. There are two basic methods – cash accounting and accrual accounting. Most large businesses operate on an accrual basis as this provides a clear understanding of what the expected business' financial position is likely to be at any point in time.

The comparison of the two approaches to accounting for capital investment noted by AER is that EnergyAustralia (EA) and TransGrid (TG) use the equivalent to the cash accounting approach for their capex (recording cash expenditure as it occurs), and the other TNSP businesses use the equivalent to an accrual accounting approach for capex which implies that all the cash is expended when the result of the capital expenditure is operational.

The need for consistency

There is little doubt that the ability to finesse the cash flow impact of investment can negatively impact the consumer side of the regulatory bargain and so leads to unjustifiable increased costs for consumers.

Experience with the way the TNSP businesses operate in the regulated environment clearly shows that given an opportunity the regulated businesses will use this to increase their revenue (eg at regulatory resets) and reduce their costs. In particular accounting methodologies and valuations are a prime source for regulatory "gaming".

Equally it is essential in order to minimise the ability to "game" the regulatory system, there is a need for regulatory consistency of approach (including any transition paths followed) for the methods used to present, and then develop, the data needed for regulatory review. There is also a need to provide a structure wherein the data is presented in a common format by all similar regulated businesses. Such an approach has been used successfully by the Essential Services Commission of Victoria, as typified in the recent review of electricity distribution in Victoria, but which did not apply, for example, with the ACCC when it recently reviewed and reset the TransGrid and EnergyAustralia transmission revenues.

The process of energy regulation in Australia is essentially based on the "notional energy business", permitting each individual business to structure and operate itself to suit its owners, whether as a listed company, privately owned enterprise or a government owned business. The regulator should not involve itself in the detail of the business structure or detailed operation, but assume that each and every regulated business in each sector is structured to the "notional" model, and that all operate effectively in the same fashion. For the regulator to assume otherwise, would require different and unique approaches for each individual business, resulting perhaps in a failure to treat each equally and causing detriment to consumers.

Regulators have accepted that all regulated businesses must be permitted to structure themselves to suit their specific needs and to provide their own accounting

systems which readily interface with any holding company and/or related business enterprises allied to the regulated business.

By approaching the regulated energy businesses on a "notional business" basis allows the regulator to ensure that each business is treated identically in terms of taxation, depreciation and the legalities associated with corporate financial reporting, and has identical obligations to consumers who are constrained to use the business which provides the needed monopoly service.

Equally to match the benefits of being a regulated business with its monopoly position, each regulated business must supply detailed information to the regulator (and Interested Parties) in a format which permits the regulator to compare like with like. This is the only tool available to regulators to impose a degree of competitive pressure to a business monopoly – by comparison of its costs and performance to other similar enterprises. This can only be realistically and effectively carried out if there is a basic assumption of equality between the businesses themselves; this highlights the need for the "notional business" approach. This in turn requires the businesses to provide information in a standard format.

It is well known that there is an asymmetry between the information and knowledge base of the business and what it provides to the regulator. One way of minimising the impact of this asymmetry is by a standard approach to information disclosure. To allow the businesses to provide information in the way that suits the business creates an opportunity for the business to "game" the regulator.

A clear example of such an approach is the use of transactions between a trust or shell company with related party or part owner. Once such example is the contract to operate the assets by a subsidiary of a part owner, where the asset owner uses the shroud of a confidential contract to prevent the regulator accessing information necessary to carry out a proper regulatory review.

For the regulator to mandate a specific approach for provision of information, can lead to the regulated business having to provide its accounting data in multiple formats – to suit the business itself, the owners and the regulator. This can result in the business incurring unnecessary costs just to comply with an edict for consistency to suit the regulator.

The implications of changing the cash flow for investments
The regulatory approach to setting revenue is based on the regulated asset base (both as a return "on" assets and "of" assets), making the valuation of the regulated asset base (RAB) is an essential element of the revenue setting. The two approaches ("as incurred" and "when commissioned") therefore result in two basic but different sets of figures for the RAB.

Consumers are concerned with two main issues in relation to accounting for capex:-

1. As the revenue for a business is based on a forecast of RAB in each year, if the actual expenditure is less than the forecast, consumers are paying a return on and of capital investment that has not occurred. This provides an

active incentive for the business to defer any investment until near the end of the regulatory period.

2. If the business is only paid for investment "on commissioning" then the business will require working capital to fund the investment up to the point where it becomes revenue earning. Thus in one case ("as incurred") the business receives revenue as it is expended, and so minimises the amount of working capital needed, and in the other case the business receives no revenue on the investment until the investment is complete and operational, which requires a higher level of working capital than when payment is made as the expense is incurred.

Examining these two issues from a consumer viewpoint:-

- To require the business to complete an investment before it is awarded any revenue (the "as commissioned" scenario) provides a pressure to complete the investment works in the shortest possible time, and not to drag out a project because the business is under less time pressure as implicit in the "as incurred" scenario.

- If the regulator permits the business a return on working capital, then in theory the two options should be cash neutral, but if the working capital allowance is structured correctly by the regulator, then again there is a time pressure on the business to complete its investment works in the shortest possible time, for to extend the process may leave the business with a period where the working capital allowance has been consumed, but without the return from the investment commencing.

AER PRELIMINARY VIEWS and MEU OBSERVATIONS

The AER provides seven items in which it presents its preliminary views – these are noted above.

Preliminary views 1 and 2

The AER notes that the "as commissioned" option is inconsistent with its ex ante approach to capex. Specifically it notes that an "as commissioned" approach will require a project specific ex post assessment for prudency and efficiency, that complex adjustments will be required to ensure the NPV will reflect the "as incurred" approach, and that it could lead to carry over between regulatory periods.

Consumers consider that these reasons do not appear to be sound.

- The AER is required to ensure that all capex effectively paid for by consumers must be prudent and efficient, whether assessed as ex ante or ex post.
- There is a fundamental concern in that why should consumers pay for investment that is not delivering a benefit – the benefit is not delivered until the investment is commissioned.
- It is not necessary to ensure that the NPV of the two approaches are consistent. Consumers pay for a service – if the service is only half built why should consumers pay for a service that cannot be provided?[1] Depreciation should only commence from the time the investment commences operation.
- Carry over between periods can be easily accommodated. Even if the investment is commenced in one period, the fundamental prudency and efficiency assessment should remain unchanged between periods. If under the "ass commissioned" approach the work is not completed in one period then the regulator does not have to address the investment in the first period, but can do so in the ensuing period. Under the "as incurred" approach, consumers will be paying in advance for investment that has not necessarily demonstrated prudency or efficiency.

The base criterion for selecting one approach over another should not be predicated on whether one approach complies with the SRP (there was significant concern expressed by consumers when the ACCC proposed its ex ante approach to capex) but whether it delivers value to both consumers and the businesses. As commissioning is a clear point in time and readily understood, to use this as a starting point for payments for service and depreciation appears more appropriate than an amorphous period of time over which a number of incomplete activities are being paid for.

Preliminary view 3

The "as commissioned" approach is administratively more complex.

This view is challenged. There is little valid explanation as to why this statement is supportable.

The use of the easement example is totally misleading. The easement provides no value to consumers in its own right – it only has value once a power line is constructed. To take this example to an absurd level, the TNSP could purchase easements extensively but not use any of them to enhance the provision of the service to consumers. Consumers would be paying for an investment that does not provide a benefit to them. To counter this view if an easement is required and is not included in the RAB until it is built on, this provides a commercial pressure on the business to ensure the completion of the investment in the shortest time.

If an investment is only recognised when it is commissioned, then there is a clear point in time (power is flowing!) when the service provision began and for depreciation to commence. For works completed during a financial year, the RAB

[1] In competitive industry, if a new processor is only half built, it cannot deliver product, and so there is no revenue attributable to the investment.

can be adjusted on a pro rata time basis. The RAB will have a more lumpy appearance but this does not cause problems to financial modelling tools.

Preliminary view 4
Regulatory accounting is different to financial accounting and either approach can be accommodated. However, there may be once "off costs" for the TNSPs to comply with the preferred approach.

The TNSPs have voluntarily entered a regulated environment. They have to provide data to the regulator in a form that the regulator can use to be satisfied that costs are reasonable. There should be no cost levied on consumers for the regulated businesses to conform to regulatory requirements.

Preliminary view 5
Consistency of data provision is necessary.

Agreed. This point is made very clearly above.

Preliminary views 6 and 7
There should be no price shocks as a result of implementing this change.

Consumers must not be exposed to any costs (whether a shock price change or a modest price change) as a result of the regulator establishing sensible rules for the regulated businesses to comply with to provide needed information in a useful form.

MEU RESPONSE TO AER QUESTIONS

1. Has the AER identified the appropriate issues? Are there other relevant matters that the AER should consider?

   MEU has provided its views above on the approaches suggested by AER. The MEU is of the view that the "as commissioned" approach to RAB adjustment with investments is the approach which replicates most closely a competitive environment. Further the "as commissioned" approach provides an inbuilt incentive on the regulated business to complete the investment in the shortest possible time.

2. Is the "as-commissioned" approach consistent with the ex-ante incentive regime established by the AER's SRP? How could the "as-commissioned" approach be applied to be consistent with the ex-ante incentive framework in the SRP?

   The AER is obliged to ensure that any investment for which consumers will pay must be prudent and efficient. Both the ex ante and ex post approaches still require the AER to perform this assessment on behalf of consumers. If the SRP does not readily accommodate recognition of the "as commissioned" approach, then the AER should change the SRP.

3. Given the issues raised in the second point, would the implementation of an "as-commissioned" approach be more administratively complex than the "as-incurred" approach? If so how material is the additional administrative complexity?

   Competitive industry follows the "as commissioned" approach. It only gets revenue from its investment after the investment is commissioned and saleable product is being produced. Why should regulated businesses be treated differently and be permitted to receive revenue when it has not provided an operational service?

4. Some TNSPs currently apply the "as-incurred" approach and some the "as-commissioned" approach. Are there costs in moving from one approach to the other? How material are they?

   These costs should, at most, be minimal. However a regulated business has to accept that as it has the benefits that flow from being a monopoly provider, this adjustment is a necessary element of providing information to the regulator in a format which allows "competition by comparison" and benchmarking.

5. If a TNSP changes its approach it may need to modify its regulatory accounts. Does this raise any accounting standards, auditing or other accounting issues?

   Both "cash accounting" and "accrual accounting" are accepted accounting methods. The approach to recording investment (either as "as incurred" or "as commissioned") should not result in any problems with standards. The AER has already noted that some businesses use the "as incurred" approach and others the "as commissioned" approach.

6. Has the AER appropriately weighed up the relevant issues in reaching its preliminary position?

   MEU is not convinced that the AER has recognized the detriments to consumers associated with the "as incurred" approach to integrating investment into the RAB.

MEU CONCLUSION

On balance as competitive industry receives no revenue until the new investment is commissioned, the MEU is of the view that the "as commissioned" approach should be the regulatory standard approach for accounting of new investment.

If this is inconsistent with the SRP, then the SRP needs to be changed. It is inappropriate for a set of developed rules to be the basis for insisting on an approach which does not reflect the most appropriate method for setting the regulatory revenue.