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Mr Chris Pattas
General Manager
Network Regulation South Branch
Australian Competition and Consumer Commission
GPO Box 520
Melbourne VIC 3001

Dear Chris

Submission by Alinta LGA Ltd

ACCC Draft Decision for Revised Access Arrangement
Submitted by GasNet Australia Limited

Alinta LGA Ltd ('Alinta') welcomes the opportunity to provide a submission on the Commission's Draft Decision for the GasNet Access Arrangement.

If required, I can be contacted on (02) 9270 4512 or email: sandra.gamble@alinta.net.au.

Yours sincerely,

Sandra Gamble
Group Manager Regulatory
Alinta Limited

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Draft Decision for Revised Access Arrangement submitted to ACCC by GasNet Australia Limited

1. Background to Alinta

Following shareholder approval of an offer from the consortium of Babcock & Brown and Singapore Power International, Alinta Limited was acquired jointly by these two companies. Subsequently, Alinta's assets have been allocated between the companies, with the majority of Alinta's electricity and gas distribution assets currently under the control of Singapore Power International.

Alinta as an independent company was well experienced in major merger and acquisition activity, having acquired the Australian infrastructure assets of Duke Energy International (2004) and the gas and electricity distribution assets of the Australian Gas Light Company (2006), and was involved in several other significant corporate realignments.

2. Major issues

The major concern of this submission is the Draft Decision's treatment of corporate synergies in the assessment of non-capital costs. The Draft Decision does not apply a basic principle of incentive regulation: that businesses should be rewarded for discovering and implementing efficiencies over the regulatory period.

3. GasNet corporate overheads/synergies

The Draft Decision puts a view that cost savings are expected from the APA Group's acquisition of GasNet in 2006 and that these hypothetical savings should be included in the corporate overhead costs proposed for the Victorian PTS. The Draft Decision estimates that the future reduction in GasNet's overheads could range from $2 million to $4 million per annum, and has settled on an estimate of $2 million per annum[1].

Alinta considers that the proposed reduction in GasNet's forecast expenditure to account for anticipated synergies:

- is inconsistent with effective incentive regulation, and
- represents an approach to regulation that will increase the perception of regulatory risk in financial markets as well as among regulated businesses.

[1] ACCC Draft Decision page 116.

4. Effective incentive regulation

Incentive regulation is carefully designed to provide distributors with a continuing incentive to pursue efficiency gains throughout the regulatory period. It would be inconsistent with this approach to transfer efficiency gains to users of regulated services before the gains have been realised, and most importantly, before the distributor has demonstrated that they can be realised. Common mechanisms to transfer realised efficiencies include a 'glide path' or an efficiency carryover mechanism.

Incentive mechanisms are also intended to provide distributors with an incentive to reveal *actual efficient costs, which* can then be used as a basis for establishing future expenditure forecasts. Again, it would be inconsistent with the incentive mechanism to transfer hypothetical efficiencies to users before the efficiencies were made.[2]

The Draft Decision follows neither of the above requirements for effective incentive regulation. It has simply assumed the value of (synergy) efficiencies obtainable by GasNet and has shifted them to users in advance of the efficiencies being achieved. Alinta considers that the Draft Decision's move away from established efficiency sharing principles will increase the perception of regulatory risk among regulated businesses since it denies them a meaningful opportunity to share in the benefits of their efficiency enhancing actions.

Further, by reducing or even eliminating incentives for regulated businesses to seek and create efficiency benefits through mergers, the Draft Decision is signalling to the market that seeking increased economic efficiency through mergers may not be a worthwhile activity.

5. The role of synergies in mergers[3]

A "synergy" is defined as the idea that the value and performance of two companies combined will be greater than the sum of the individual parts.

For the most part, acquiring companies nearly always pay a substantial premium on the stock market value of the companies they buy. The justification for doing so nearly always boils down to the notion of synergy; a merger benefits shareholders when a company's post-merger share price increases by the value of potential synergy.

It would be highly unlikely for rational owners to sell if they would benefit more by not selling. That means buyers will need to pay a premium if they hope to acquire the company, regardless of what their pre-merger valuation tells them. For sellers, that premium represents their company's future prospects. For buyers, the premium represents part of the post-merger synergy they expect can be achieved. The following equation offers a conceptual framework for synergy and determines whether a merger is worthwhile. The equation solves for the minimum required synergy:

$$\frac{\text{Pre-Merger Value of Both Firms} + \text{Synergy}}{\text{Post-Merger Number of Shares}} = \text{Pre-Merger Stock Price}$$

In other words, the success of a merger is measured by whether the value of the buyer is enhanced by the action. However, the practical constraints of mergers often prevent the

[2] Given that the regulated business is already operating within a framework of efficient costs.

[3] This section is adapted from the synergy topic in the on-line investor service "Investopedia" owned by Forbes Media Company at http://www.investopedia.com/university/mergers/mergers2.asp

expected benefits from being fully achieved. The synergy that was promised might simply not be realised in practice.

6. Synergies and regulation

Synergies are a particular way of realising efficiencies in corporate amalgamations, and are made up of several elements, including:

- eliminating duplication and overlap
- general cost cutting
- increased productivity and corporate learning
- additional economies of scale and scope
- greater purchasing power

However, most of these synergies cannot immediately be realised at the date of the merger. Mergers involve an integration process that requires time, effort and cost. If a regulated business is part of a merger, then the regulator should use an incentive approach; that is, the business should be given time to procure potential synergies. The regulator should then use an incentive mechanism to allow the business to retain synergies for a period before transferring them to users.

Alinta also notes that the Draft Decision has not identified and allowed for the historical and future costs and risks incurred by a merged business in realising the assumed synergies.

There is a risk that any merger may not achieve the level of synergies expected, resulting in the merging parties bearing all the actual merger costs but not achieving the forecast benefit. The forecast net benefits from synergies must be sufficient to make the merger attractive. The ability of regulators to prematurely remove potential benefits after the merger - before either the benefits or the full costs of acquisition and integration can be quantified - will not only reduce the forecast merger net benefit, but will create the potential for an increased net loss. This is precisely why pre-emptive regulatory actions on synergies will discourage merger activity.

7. Conclusion

Alinta submits that that the Commission should adopt an incentive-based regulatory approach to dealing with synergies in the GasNet Final Decision. This requires waiting until ongoing (net) synergy benefits have been be achieved and quantified before sharing the benefits with users through a recognised mechanism.