

# *Energy Users Coalition of Victoria*

**Australian Competition and Consumer  
Commission**

**Victorian Gas Transmission Revenue Reset**

**AER Draft Decision on GasNet Application**

**A response**

by

**The Energy Users Coalition of Victoria**

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**Assistance in preparing this submission by the Energy Users Coalition of Victoria  
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**The content and conclusions reached are the work of the EUCV and its  
consultants.**

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## **Executive Summary**

The Energy Users Coalition of Victoria (EUCV) provides brief comments on the ACCC's draft decision on the GasNet application.

The EUCV considers that the draft decision is too generous to GasNet and notes that:-

- The starting point for efficient opex has been set at a level above the average of the four years of actual opex
- The new capex allowances are well in excess of the actual AA2 capex for the period, despite the under-run on past capex
- Demand is forecast to be less than AA2 and yet there has been an increase in opex and capex to "compensate" for the reduction in demand

The EUCV has identified issues that the ACCC should examine more closely viz:

- the reasons for causing the step changes in Opex
- the inclusion of a special allowance for labour cost increases
- the inflation forecast
- elements of the WACC
- demand forecasts and the associated capex

## **1. Introduction**

The EUCV has reviewed the ACCC Draft Determination on the GasNet application to increase the costs for providing gas transmission services in Victoria. Overall, the EUCV remains very concerned that despite the approach used by ACCC to reduce the excessive costs claimed by GasNet under its new owner APA, the ACCC is still of the view that GasNet should receive an increase in costs to provide the service.

In the ACCC review AA2, the GasNet tariffs were reduced in real terms due to a realistic opex and capex regime achieved after the ACCC adjusted the GasNet revenues in 2002. Over the AA2 period, GasNet has needed less opex than the ACCC considered prudent, and identified that there was a need for less capex than was approved. As a result, GasNet was a significant beneficiary of significant cash returns by achieving these under-runs.

The purpose of allowing GasNet to retain the benefits of an under-run in approved costs (and to have these benefits into the next period) is that this provides an incentive for GasNet to set its most efficient costs. These maximum efficiency based costs then provide the starting point (subject to identified step changes) for setting future costs for the business. We are most concerned that the ACCC has decided that whilst the principle might be appropriate it has been liberal with the application, resulting in higher than needed allowances being provided.

In particular the EUCV notes that:

- The starting point for efficient opex has been set at a level above the average of the four years of actual opex
- The new capex allowances are well in excess of the actual AA2 capex for the period, despite the under-run on past capex
- Demand is forecast to be less than AA2 and yet there has been an increase in opex and capex to “compensate” for the reduction in demand

## 2. Step changes

There has been little analysis of the reasons supposedly causing the step changes in opex, other than they “are considered appropriate”. It is not sufficient to consider that the costs are appropriate to reflect the change, but to assess whether there has been a step change in requirements since the last reset in 2002.

One of the significant issues that the ACCC has not addressed is the extent of changes that resulted in lower costs, and it has only addressed costs that might have increased. The way other jurisdictional regulators have addressed this asymmetry, is to be very definitive about what constitutes a step change. They have decided that there has to have been a clear change in external requirements on the regulated business before a step change is warranted. It has not been sufficient that the regulated business decides that they intend to do “a bit more” to meet requirements that were in place prior to the last review.

For example, that the ACCC considers there is increased lighting cost is reasonable, yet this could/should have been in place in 2002. Another example of this is that an “ageing” workforce has been an issue since before 2002. Neither of these issues warrants to be identified as a step change since 2002.

In other cases, costs will be absorbed into the general inflation. For example, it is not anticipated that the new accounting standards will require more attendance than applied prior to 2005. All companies are required to comply with these new requirements and if they do cause increased costs than this will be reflected in increase in costs across the nation and therefore integrated into the CPI. The ACCC has already allowed for GasNet to increase its costs due to inflation, therefore those step change costs which are applicable to all companies will be passed through to GasNet. If this allowance is included in the GasNet step changes, then GasNet will be granted a “double dip”.

The EUCV notes that GasNet has requested and the ACCC agrees that there is a need for increased opex to reflect the amount of new pipelines that are to be built. The EUCV considers that the ACCC needs to adjust these allowances to reflect the exclusion of these new pipelines from the approved capex.

The EUCV is of the view that only changes that were initiated due to a change in requirement since the last reset are eligible to be classed as step changes, and that these are unique to GasNet.

### **3. Opex elements**

#### **Fuel gas**

We note that the ACCC has elected to allow the costs of fuel gas to be a pass through amount, and that the opex allowance excludes this element. Due to the large risk exposure to price we agree this is a sound strategy. However, this will remove the controls on GasNet to be prudent with the usage of the gas, so we recommend that the amount of fuel gas to be used should be fixed so that the only exposure that consumers see is to the price changes.

#### **Overhead reduction**

The EUCV agrees that there should be a reduction in overheads by the amalgamation of GasNet within APA, and that this benefit should be incorporated

#### **Equity raising costs**

The EUCV agrees that as the equity needed for GasNet assets has already been raised, there should be no additional allowance for it to be raised again

#### **Inflation of labour**

The EUCV does not agree with the analysis of the ACCC with regard to the inclusion of a special allowance for labour cost increases expected over the next five years. The ACCC refers to work carried out by Econtech for the AER. We have concerns with the Econtech assessment and believe it should be treated with extreme caution by the ACCC. Our reasons for this are as follows:-

Econtech P/L was requested by AER to examine the SP Ausnet forecasts of labour cost increases, and reference is made to this in the GasNet draft decision. The EUCV sees that the Econtech review does not provide a sound view of the likely wages growth in Utilities in Victoria (or other states). The EUCV reasons are as follows

Econtech is of the view that the costs for labour needed by Utilities over the next 6 years will outstrip the state average of wages growth, effectively supporting the view put by GasNet. This is depicted in table 6.4 on page 39 of the Econtech report o SP Ausnet (included below). The detailed development of its reasons based on various forecasts appears to be consistent with the methodology used by other forecasters, but the outcomes appear to be inconsistent.

**Table 6.4**  
**Labour Cost Growth Rates in Victoria, 1995/96 to 2015/16 (%)**

	Mining	Electricity, Gas & Water	Construction	Overall Victoria
1995-1996	14.9%	3.9%	4.4%	3.7%
1996-1997	18.7%	3.4%	3.5%	1.7%
1997-1998	23.8%	9.0%	11.1%	4.8%
1998-1999	2.5%	0.2%	-5.7%	1.4%
1999-2000	-8.8%	11.8%	-6.4%	1.6%
2000-2001	-1.7%	6.6%	3.6%	4.6%
2001-2002	-6.4%	7.5%	2.7%	4.9%
2002-2003	31.4%	1.0%	15.9%	7.7%
2003-2004	15.9%	-2.0%	4.1%	4.6%
2004-2005	2.8%	2.8%	-0.7%	2.7%
2005-2006	5.2%	4.1%	7.2%	4.4%
2006-2007	5.7%	1.8%	2.1%	2.9%
2007-2008	4.3%	5.9%	4.6%	5.5%
2008-2009	3.9%	6.0%	4.3%	5.1%
2009-2010	3.8%	7.6%	4.9%	5.4%
2010-2011	3.5%	7.0%	4.9%	5.2%
2011-2012	3.6%	6.2%	4.8%	5.1%
2012-2013	3.9%	5.9%	4.8%	5.0%
2013-2014	3.8%	5.6%	4.4%	4.5%
2014-2015	3.2%	5.0%	3.4%	3.5%
2015-2016	2.7%	4.7%	3.4%	3.5%

Source: LCM

Econtech provides support for its forecast by reference to the growth in Utility sector wages during the late 1990s and early 2000s. There are some inconsistencies in this approach by Econtech.

1. There is an assumption that there was a wages growth during the deregulation process. In fact there was no significant growth in wages per se in this period, but a culling of large numbers of lower paid worker positions. The Utility sector was renowned for this practice as it transited from being directly government controlled to being corporatized. The direct result of this culling process was a statistical increase in wages paid rather than a process of massive wages growth.
2. The technical skills needed by the Utilities sector fall into two distinct categories – operations and maintenance labour and construction labour. The bulk of new investment by the Utilities sector is carried out a construction activity. This is a distinction drawn between by Econtech between Utilities and construction, yet does not exist in reality. Many of the skills needed for operation and maintenance are similar to those needed for construction and mining, yet Econtech continues to develop the concept that they are different. Thus for

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Econtech to develop a model which delivers different outcomes for different industries seeking the same skills set seems to be counterintuitive.

3. Econtech draws comparisons between Mining, Construction and Utilities in Victoria, yet opines a view that all will be subject to the pressures for mining and infrastructure in other states, yet then determines that there will be differing outcomes for each of the Victorian sectors examined.
4. There is no analysis of the statistical errors that can occur in what are relatively small samples of employment. Mining and Utilities sectors in Victoria employ a relatively small proportion of the total Victorian labour force, and as a result apparently large proportional changes can be the result of a relatively small number of very large wage movements.
5. Some better analysis is required to assess whether the wages growth forecasts reflect the actuality of the labour forces used in each of the sectors. Econtech makes the rash statement that as the "...electricity, gas and water industry employs a large proportion of electricians, electrical engineers and engineers..." this reflects the wages pressures resulting from the skills shortages endemic in the country. In fact the numbers of employees with these skills needs is not as high as needed, for example, in the construction industry. What Econtech should do is to analyse changes in the median wages rather than averages of total wages, as the median wage is more reflective of the wages cost for the bulk of the work force.

These essential inconsistencies can have a significant impact on the forecasting process.

Econtech attempts to provide some qualitative reasoning behind its forecasts. For instance in its report to AER on SP Ausnet (page 41) Econtech opines that:-

"The historically higher wage growth in the utilities sector has largely resulted from the recent restructuring in the electricity, gas and water industry. The drive for increased productivity in the industry is expected to have led to a fall in lower-skilled workers, as the industry continued to become more capital intensive. As the lower-skilled workers were displaced, strong growth was achieved in the average wages in the industry.

Higher wage growth in the utilities sector, at the national and state levels, is expected to continue due to a number of different factors. In particular, as mentioned in the earlier section, the utilities sector is experiencing the scarcity of skilled labour that is currently affecting most of Australia.



The electricity, gas and water industry employs a large proportion of electricians, electrical engineers and engineers. As such, it faces competition from industries such as the construction industry and the mining industry for the same type of skilled workers. With the mining and construction boom expected to last for another couple of years, this will continue to boost wages in these industries. In turn, wages for the utility sector will need to also increase so the industry can continue to attract skilled workers.”

As noted above the inconsistencies we have noted are perpetuated. Apparent wages growth in 1990s was more a result of culling lower paid jobs, resulting in a statistical increase in average Utilities wages.

The need for skilled employees in the mining and construction sectors is just as high a priority as in the Utilities sector, yet the wages growth for the Utilities is forecast to be higher.

Nearly all of the capital expenditure of GasNet (and indeed most of the businesses in the Utilities sector) is contracted out to construction businesses. Even many of the maintenance activities are contracted out to other businesses. If such a large element of the work assumed to be included in the Utilities sector is contracted out and therefore not included in the Utilities direct workforce, then to what degree is the development of a Utilities wages index representative of the actuality of the assumption that the Utilities sector wages growth is directly related to the costs incurred.

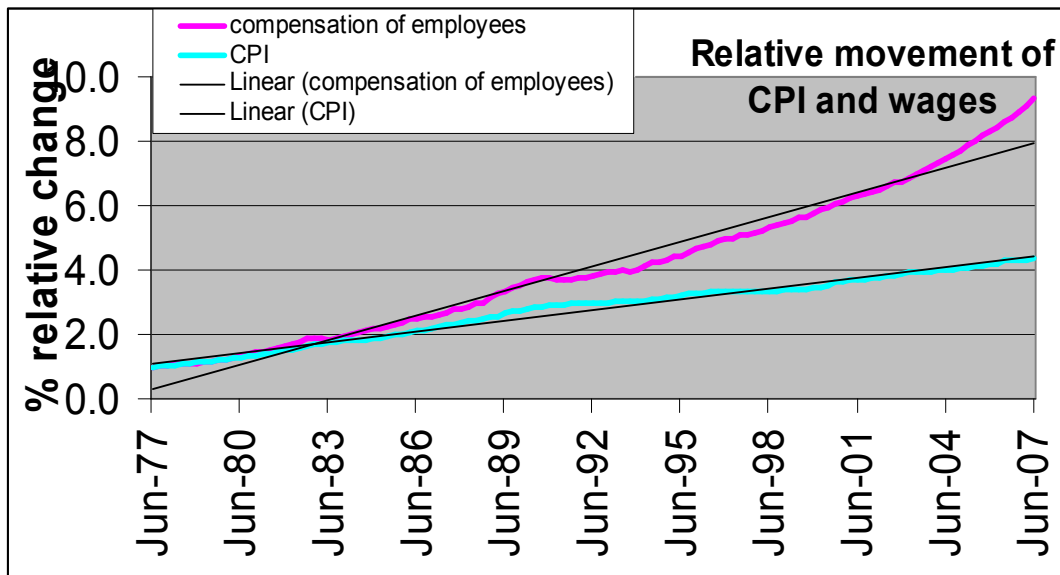
The EUCV is of the view that as there is a such a disconnect between the outcomes for the three sectors quantified by Econtech, and it is assumed that all three are subject to essentially the same pressures from competition for skilled labour, there has to be a reason for the disconnect. This could very well be that the Utilities have reduced their direct work forces significantly during deregulation, mainly by culling lower paid workers. This has been exacerbated by the Utilities electing to contract out construction and maintenance functions resulting in the Utilities retaining a small core of highly paid employees to supervise contracted out work. The EUCV supports this approach (in fact many members of EUCV also contract out elements of what used to be core activities) as it can result in significant efficiencies.

What is not examined by Econtech, GasNet or the ACCC is that during the current period (AA2) wages have been growing at quite high rates, yet GasNet actual opex costs have remained relatively static. Thus Econtech has overlooked the fact that a large element of the forecast wages growth has been accommodated by GasNet within its opex allowances.

The EUCV is of the view that the Econtech report needs to be reviewed in proper context because:-

- The expected higher wages growth forecast for the Utilities sector over the next few years has to be treated with extreme caution, as the Utilities wages are not necessarily representative of the employment profile of SPA
- There is not sufficiently close a relationship between wages growth and actual opex to be able to confidently extrapolate an increased allowance for opex based on expected wages growth
- Capex is more related to wages growth in the construction sector than to the Utilities sector, and therefore the construction sector wages growth is more likely to be representative of capex growth for the Utilities sector.

The following graph shows the relative movement in wages (via compensation of employees) and CPI over the past decade.



Source RBA

This shows that growth in employee compensation has consistently outperformed CPI over the past 30 years. In fact the trend lines imply that CPI has grown at an average of about 5% per annum over this time, and wages have grown by an average 7.2% (or higher) over the same time, implying that wages have always outperformed CPI by at

least 2.2% (and probably higher) and the view that this is an anomaly applying only to the near future the current time is purely fallacious.

The ACCC makes reference to BIS Shrapnel forecasts of wages, implying that the BIS forecast support the Econtech contentions. However, both in their expectations have forecast inflation lower than the AER proposes for its WACC. If the inflation rate as calculated from inflation swaps is used (ie an independent expectation of inflation based on what businesses are prepared to spend money on) then the inflation expectation of Econtech is significantly in error, and so is the BIS forecast. If 3%<sup>1</sup> expected inflation is used then the estimate of real wages growth forecast by both Econtech and BIS is much lower than that stated by both and much more closely aligns with the historic premium of wages over inflation of 2.2%.

The EUCV considers that if there is an underlying trend for wages to consistently demonstrate a premium over CPI, then the ACCC must, as a matter of equity to consumers, allow only an adjustment for the premium between the underlying trend and the expectation for the next period. For the ACCC to allow the full differential between wages and CPI as a basis for a step change, will create a regulatory precedent and enshrine this approach into the future.

The differential between wages and CPI is effectively the improvement in productivity of labour over time. The ACCC has not proposed to build into the allowances for labour a fixed reduction for productivity improvement. This is on the basis that up to now, regulators have implicitly assumed this is included in the wage premium over CPI. To exclude the underlying premium and grant the full differential as is proposed, is illogical and a clear bias against equity to consumers.

The EUCV considers the ACCC should not accept that there is a wages change that warrants adjustment for this new period, as wages have consistently outperformed CPI over the long term, and the forecast premium is not significantly different from the past. At most, the ACCC should only allow for the premium in wages over the underlying

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<sup>1</sup> In section 4 the EUCV refers to the forecast of inflation by the RBA. The RBA expects inflation to be 3.25% for the coming few quarters. Using RBA assessments implies that the wages premium is even lower than that implied by a 3% inflationary figure

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wages premium over CPI, and use the inflation estimate it sets for the WACC as the forecast of inflation when developing the wages premium over CPI.

However, the EUCV advises caution in agreeing to include the premium of wages for AA3, due to the asymmetry risk of doing so.

It is in the aspect of forecasting capex and opex that this asymmetry has been overlooked. Where previous costs have risen less than CPI, it has been ignored that the regulated business would have accrued an unearned benefit where costs increased at a rate less than CPI. In fact where this has resulted in an apparent “efficiency gain” the regulators have permitted the business to retain the benefit and have additionally carried forward an efficiency bonus into the next period.

In principle consumers have seen that this efficiency mechanism should lead to an overall benefit to consumers, and any unearned benefits (such as from costs being less) will not be deducted by the regulator. However where the businesses see that this general approach might not be to their benefit, they request some additional recognition of the potential downside to them.

The fact that the ACCC has accepted in principle that GasNet is entitled to an increased allowance because the market seems to be going against the business. Yet the ACCC has not required the business to return any unearned benefits due to market conditions favourable to the businesses. This is inconsistent and needs to be recognised.

The EUCV is of the view that either the ACCC should not permit an increased allowance due to expected unfavourable market conditions, or it should include adjustments for all market condition movements. The EUCV considers that allowing adjustment for market conditions (which are faced by all businesses) is a movement towards cost plus regulation, rather than incentive regulation.

There is already an Australian regulatory precedent for the ACCC not to make adjustments for expected unfavourable market conditions. This relates to the use of a market risk premium of 6%. In previous decisions regulators (including the ACCC) have observed that the current market risk premium is less than the 6% used. They have stated that the regulatory approach is based on consistency and long term assessments and that the longer term view should prevail.

The EUCV points out that over time CPI will adjust, in the long term, for short term movements of individual costs, just as does the market risk premium. The AER should retain the view that over the long term, CPI will accommodate all of the individual short term price movements expected in the market (including labour), and therefore should not allow for short term adjustments that are biased in one direction.

## 4. WACC elements

### Inflation

The general acceptance is that the indexed CGS rate is deflated in yield due to a scarcity factor but that the nominal CGS yield is a good basis of the “risk free rate” means that regulators have to secure very sound input to inflation over the coming regulatory period in order to set a soundly based risk free rate. The ACCC has assessed the inflation requirement as 3%.

If the nominal rate is accepted as being a reasonable assessment of the risk free rate, then the selection of the inflation rate become critical to the development of the “real” risk free rate that is used to develop the revenue requirement for the regulated business.. This then requires considerable effort to forecast future inflation

In fact, this might not be as challenging as first thought. Analysis of the yields for different duration bonds seems to imply that the inflation expectation built into nominal bonds is not reflective of the duration of the bond – that is, the inflation forecast the market builds into the bonds is much the same for short term bonds as for long term securities. As noted by the AER in its assessment of SP Ausnet the implied inflation derived from inflation swaps indicates an inflation estimate of 3.37% (page 123)

#### “Inflation swaps

On the 6 August 2007, Bloomberg displayed the prevailing rate on a 10 year inflation swap to be 3.37%. This rate essentially represents the mid price at which the market is buying/selling 10 year inflation contracts based on CPI. The AER notes that whilst inflation swap rates give an estimate of the price at which firms can hedge inflation risk, they may not necessarily indicate the market’s expectation of inflation. The swap rate is likely to include a positive or negative inflation risk premium, though of an unknown magnitude. The AER does contend though, that whilst inflation swaps may not produce the best estimate of forecast inflation, the prevailing rate on the 10 year inflation swap does support a general inflation forecast of 3%, as opposed to 2% or 2.5%. This conclusion is drawn from the analysis that if an inflation forecast of 2.0 % or 2.5 % was determined, the current yield on inflation swaps would indicate that these inflation swaps include a positive inflation risk premium in the order of 137 bp or 87 bp, respectively.

These observations then add considerably to the debate, as the observations imply that the market is not forecasting inflation over the duration of the life of the security, but the inflation seen in the short term only. The repercussions of this are profound in an

environment where there is definite concern that indexed CG securities are being overvalued (ie understated in yield) due to their relative scarcity.

In its final decision on GasNet in 2002, there was considerable debate as to the duration of bonds to be used for the risk free rate. The ACCC identified that the inflation derived from 5 year indexed and nominal bonds was the same as that derived from 10 year bonds (page 89). If different duration bond yields have essentially the same inflation component, then it is incorrect to assume that the difference between nominal and indexed securities provide an inflation figure which is expected to apply for the entire regulatory period; it becomes then an assessment of what the short term inflation is likely to be. This short term figure is then the adjusting amount that should be used to convert nominal bond yields to “real” bond yields.

In the past regulators used indexed bonds to set the “real” risk free rate – this was a correct approach. They used the difference between the indexed bond and the nominal bond to set a forecast for inflation to develop the revenue requirement. If this forecast was incorrect, there was no residual impact on the regulated business as the business was able to adjust its revenue during the period to match actual inflation. In fact the inflation forecast for the AA2 for GasNet was 2.16% and in actuality the average inflation for the past five years (Sep/Sep) has been 2.8%.

In the post indexed bond era, setting inflation for the revenue requirement still remains as it was – the revenue is adjusted annually to reflect actual inflation and so is not a major issue if it is not quite right.

However, for setting the risk free rate which is the basis of the revenue requirement, setting the inflation rate too low will give the regulated business a windfall profit. Setting the inflation rate too high will result in the business having too low a revenue stream.

The ACCC has decided that for GasNet the forecast of inflation will be 3% and has used this figure to convert nominal bond yields to “real” bond yields so as to set the “real” risk free rate. They have decided that this is appropriate because the RBA will act to keep inflation within the range of 2-3%. However if the market has built in an inflation forecast into nominal bond yields which reflects current inflation, then there will be an error in setting the risk free rate.

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The RBA has assessed that the current and forecast inflation for the economy is as shown on the following table; this table is from of a series of the monthly bulletins from the RBA<sup>2</sup> about the economy.

**Table 16: RBA Inflation Forecasts<sup>(a)</sup>**  
Percentage change over year to quarter shown

	Dec 2006	June 2007	Dec 2007	June 2008	Dec 2008	June 2009	Dec 2009
Consumer price index	3.3	2.1	2¼	3¼	3	2¾–3	2¾–3
Underlying inflation	3.0	2.8	3¼	3¼	3	2¾–3	2¾–3

(a) Actual data to September 2007. Underlying inflation refers to the average of trimmed mean and weighted median inflation. For the forecast period, technical assumptions include A\$ at US\$0.93, TWI at 73, cash rate at 6.75 per cent, and WTI crude oil price at US\$90 per barrel and Tapis crude oil price at US\$92 per barrel.

Sources: ABS; RBA

Thus if the nominal bond rate includes only for short term inflation expectations (and after some thought, intuitively this would be the expectation) then the ACCC should use short term assessments of inflation for developing the “real” rate from the nominal rate.

The EUCV recommends that the ACCC use the as the inflation rate to convert nominal bonds to the “real” risk free rate of 3.25%. This is comparable to the inflation expectation built into Bloomberg inflation swaps currently at 3.37% as identified by AER for SP Ausnet.

The ACCC should use the expected long term inflation rate for the basis of developing the revenue stream, as the setting of the inflation rate for this purpose is not critical and is adjusted annually to actual inflation throughout the regulatory period.

**Credit rating**

In its final decision on GasNet in 2002 the ACCC set a credit rating of BBB+ based primarily on an assumed gearing of 60debt: 40equity. In the draft decision the ACCC has noted that the gearing of APA is 70% debt yet accepts that GasNet debt should be rated at BBB rather than BBB+. Whilst it is possible that the higher gearing of APA has

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<sup>2</sup> RBA STATEMENT ON MONETARY POLICY – NOVEMBER 2007, table 16. The expectation is that the RBA will provide this information on a regular basis so that independent assessments of inflation are available.



downgraded the GasNet credit rating to BBB, the ACCC has retained the gearing at 60% debt, which would imply a higher credit rating.

The EUCV considers that there is no substantive reason that if the gearing is assumed to be 60% debt, that the credit rating for the notional business should be downgraded from the BBB+ used by the ACCC in 2002.

### **Gearing**

The EUCV notes that the ACCC has persisted in maintaining gearing at 60% debt, despite clear evidence that actual gas transport businesses operate at higher levels than this, and yet still have high credit ratings.

The outcome of maintaining this notional gearing level despite the fact that actual gearing is higher than this level increases the nominal vanilla WACC by some 43 basis points. Or demonstrated in another way, it adds some \$2m pa to the GasNet revenue increasing tariffs by ~2.5%

The ACCC must address why it persists in granting a higher WACC to businesses than they incur due to using a gearing that is too low for the market.

### **Equity beta**

The ACCC has maintained an equity beta of 1.0 for this GasNet decision. The EUCV has maintained for many years that this figure is too high, and provided evidence that the Utilities sector as a whole operates at an equity beta of 0.7 or lower.

This lower figure is based on direct experience of utilities businesses operating in Australia. At the 2002 reset there was limited data of Utilities performance in this country and the ACCC had doubts about using data based on the performance of gas Utilities in the US, particularly as these might have been impacted by the "Tech bubble". This is no longer the case.

Jurisdictional regulators have used lower equity betas for gas distribution businesses in recent years. In SA the local gas distribution business (Envestra) was granted an equity beta in the range of 0.8-1.0 which was fixed to 0.9. A year later in Victoria the regulator settled on an equity beta for gas distribution for current conditions in the range of 0.5-0.8 which was fixed at 0.8. In particular the analysis of the Victorian regulator was extraordinarily detailed.

The analysis used by the ACCC for assessing a current level of equity beta basically consisted of "maintaining the status quo" was more important than using inputs that have considerable force of evidence. The ACCC notes (page 85) that

“...in the context of establishing the national regulatory framework for electricity and gas transmission and distribution networks, including the establishment of the AER as the national regulator, the ACCC considers it is important to have due regard to consistency and continuity in regulatory decisions, unless a compelling case can otherwise be demonstrated.”

The EUCV considers that this is a “cop out” and the ACCC is conferring an unnecessary premium of cost onto consumers. There is now compelling evidence developed by two jurisdictional regulators (and upheld in the courts in the case of the SA decision) that an equity beta of 1.0 is too high. The only reason the ACCC has to maintain an equity beta at 1.0 is in the cases of reviews by the AER for the electricity transmission businesses and the NSW electricity distribution businesses where an equity beta of 1.0 is stipulated in the Rules applying to those reviews.

In its draft decision on GasNet in 2002 the ACCC commented that (page72)

“...the equity beta for GasNet will be 1.0 for this Draft Decision. This represents the absolute upper limit of a possible range for the equity beta suggested by ACG analysis of available empirical evidence.”

For its final decision on GasNet in 2002 the ACCC was provided with evidence that an equity beta of 1.0 was too high and the ACCC commented that (page 109)

“It should be noted that the Code makes it incumbent upon the Commission to adopt parameter settings relevant to current financial markets. Accordingly, when parameters used in the past have been found to be inaccurate or based on incomplete information there is a requirement to adjust the parameters. This is the situation with the beta estimate.”

It was on these bases that the AA2 decision was made in regard to equity beta, and the expectation of consumers (and the ACCC) was that as more detailed information was provided, the ACCC would review the parameter so that it represented a forward looking estimate for a regulatory period.

The ACCC (and others) has now been provided with evidence that an equity beta for gas transport businesses at 1.0 is too high, and that a lower figure should be used. **Under the Gas Code, the ACCC does not have the power to allow a high equity beta to be included just because it intends to carryout a detailed assessment of equity beta and other WACC parameters at a later time. The ACCC must, if there is sustainable evidence use a contemporary assessment of equity beta.**

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That the jurisdictional regulators in SA and Victoria have done so an reduced equity beta for gas distribution must be strong evidence that the equity beta for GasNet at 1.0 is too high, and must be reduced.

## **5. Demand assessment and associated capex**

The ACCC has identified that the expected consumption in the period AA3 will be lower than that which occurred in AA2. It has then required GasNet to use these lower estimates of future demand and consumption in development of its tariffs.

The EUCV accepts that the lower demand and consumption figures are based on VENCORP assessments, and the EUCV does not have any data on which to dispute these. What the EUCV does do though, is query that if the demand for gas is falling vis-à-vis AA2 then for the ACCC to accept that there is a need to increase the size of the GasNet system appears to be based on contradictory information.

In particular, the EUCV notes that the ACCC has determined that a number of major augmentations proposed by GasNet should not be included in the capex allowance as they do not meet the prudence investment test or need to comply with the economic feasibility test in order to gain approval. The EUCV considers that with a reduction in forecast demand there can be little justification for increasing the geographical scope of the GasNet network.

Further, the EUCV notes that there are provided some justifications for augmentations due to the increase in short term demand, but which create little additional consumption – that as the load factor is forecast to reduce there is a need to increase the short term carrying capacity. The EUCV accepts the logic of this need to augment, but adds that the ACCC needs to be very careful that these costs are carried by those causing the need, rather than the costs being smeared across all users.

Finally, the EUCV notes that the network needs to be augmented to provide (replace?) additional capacity in the network to allow the Interconnector to operate at full capacity. The EUCV does not consider that the ability of export gas to other regions should be provided at the expense of Victorian consumers of gas. If the consumer of gas in the NSW region requires gas from Victoria, then the “causer” (ie the interstate user) of the need should pay for the costs associated with its provision. This concept is no different to that used for supplying gas to NSW via EGP. It is inappropriate that a user of gas in NSW should be provided with use of gas capacity at the expense of other consumers. To do so creates the potential for “free riding” and a lack of competitive neutrality between different suppliers of gas carrying capacity.