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By Email: gns@accc.gov.au

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

Dear Mr Pattas,

Re: Submission by Multinet Gas Partnership

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

Multinet Gas Partnership (Multinet) welcomes the opportunity to provide a submission on the Commission's Draft Decision for the GasNet Access Arrangement.

Yours faithfully

Hugh Gleeson
Chief Executive Officer

Submission by Multinet Gas Partnership

ACCC Draft Decision for Revised Access Arrangement -

GasNet Australia Limited

1. Background to Multinet

Multinet Gas is one of three gas distribution businesses in Victoria and is the largest urban distributor, servicing some 700,000 gas connections in Melbourne's eastern suburbs.

2. Major issues

- The Draft Decision does not implement a key principle of incentive regulation that rewards businesses by allowing them to retain realised efficiencies for a period of time. This omission is evident in the Draft Decision's treatment of corporate synergies when it addresses GasNet's forecast corporate overheads;
- Certain WACC parameters determined for GasNet are not consistent with the results of recent expert investigations which recommend alternative values. Multinet has addressed a similar issue at considerable length in the current Victorian Gas Access Arrangement Review.

3. Corporate synergies in GasNet overheads

The Draft Decision notes that GasNet did not propose any reductions in corporate overheads resulting from cost savings expected from the APA Group's acquisition of GasNet in 2006. 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].

Multinet considers that this action is inconsistent with effective incentive regulation and, in fact, creates a barrier to efficiency creation by businesses for the reasons given below.

(a) Established efficiency sharing principles should be followed

It is established regulatory practice to delay the transfer of efficiency gains realised by regulated businesses (including corporate synergies) to users of regulated services. A common mechanism is a 'glide path' (ie a price or revenue path) which gradually returns efficiencies and synergies to users. Another method is an efficiency carryover mechanism, as used in Victoria. These mechanisms are designed to give businesses an incentive to seek efficiencies.

The Essential Services Commission of Victoria has given a clear explanation of the incentive principle in the recent Multinet Draft Decision[2]:

> *The ECM [efficiency carryover mechanism] provides a financial reward (penalty) for efficiency gains (losses) achieved compared to the expenditure benchmarks for the*

[1] ACCC Draft Decision page 116.
[2] Essential Services Commission, Gas Access Arrangement Review 2008-2012 Draft Decision, 28 August 2007, page 505 [quote abbreviated].

> *regulatory period. Any rewards (penalties) are included in the revenue requirement used to determine prices in the subsequent regulatory period.*
>
> *The ECM was designed to provide the distributors with a continuing incentive to pursue efficiency gains throughout the regulatory period and to reduce the incentive to defer the pursuit of efficiency gains that might otherwise exist immediately before a regulatory review.*
>
> *The ECM allows for the efficiency gain (loss) achieved by the distributor to be retained for a further five years following the year in which the efficiency gain (loss) is made. This approach provides the same reward (penalty) for an efficiency gain irrespective of the year in which that particular gain (loss) was made. ------- the ECM is 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.*

The above reasons provide a solid case for regulators to retain effective efficiency sharing mechanisms. Multinet observes that the essential elements of an incentive approach to cost determination are:

- allowing a business to initially discover and realise available efficiencies
- allowing a business to retain these efficiencies for a period of time
- using a mechanism to transfer the efficiencies to users in subsequent regulatory periods.

Synergies resulting from corporate amalgamations are a particular way of realising efficiencies, and may (over time) involve a combination of elements such as:

- cost reductions from eliminating duplication
- greater productivity and corporate learning
- additional economies of scale
- additional economies of scope.

By their nature, these efficiencies cannot be obtained instantly. All corporate mergers involve an integration process that requires time. If it is determined that actual efficiencies can be realised, regulators should use an incentive approach. Regulators should allow businesses time to procure the efficiency gains, and allow businesses to retain them for a period before transferring them to users.

In contrast, the Draft Decision has simply assumed the level of efficiencies obtainable[3] and has prematurely shifted them to users. Multinet considers both these actions set undesirable precedents by (a) not following established efficiency sharing principles; and (b) reducing or even eliminating incentives for regulated businesses to seek and create efficiency benefits through mergers. From the perspective of the economy as whole, the Draft Decision signals that seeking to increase economic efficiency through mergers may not be a worthwhile activity if assumed economic benefits can be appropriated by regulators in the short term.

(b) Consistency with Code requirements

The GasNet access arrangement review is being conducted under the Gas Code (and not the new Law and Rules). Multinet considers that the Draft Decision's approach may not be consistent with the s 8.1 principles of the Code. For example, s 8.1(d) requires that a reference tariff policy objective is to '*provide an incentive to the Service Provider to reduce costs and to develop the market'.* Multinet does not see how appropriating corporate

[3] Section 5.1.5 of the Draft Decision in effect predetermines APA's future corporate overhead policy in relation to GasNet.

synergies before they have been realised and transferring them to users would contribute to this objective.

(c) Consistency with relevant overseas examples

Multinet observes that there are many examples of overseas regulatory approaches that allow sharing of net merger benefits between customers and shareholders. For example, in a 2006 paper Gordon and Olson argued that:

> *Given the potentially significant efficiency benefits that mergers can provide, ensuring that the combined utility's shareholders receive a share in the benefits of the merger is more than reasonable, it is an essential regulatory tool.*[4]

The paper cites several examples of regulators allowing the sharing of merger benefit between businesses and consumers in the US[5].

The UK regulator has also recognised the efficiency benefits of corporate mergers, and in a 2002 policy statement said:

> *For all mergers which take place following this policy statement, Ofgem's policy will be to identify savings from the merger as part of its work on operating and capital cost efficiency more generally. Savings from mergers will not be separately identified.*[6]

Multinet submits that the overseas examples cited above are an appropriate regulatory response to merger activity.

(d) Need to factor in the costs of achieving benefits

The Draft Decision's assumed synergies for GasNet have yet to be realised. Further, the Draft Decision has not identified and allowed for the costs and risks that have been and will be incurred in realising the assumed synergies. Multinet suggests that this is an unbalanced approach to regulation that will increase the perception of regulatory risk in financial markets as well as among regulated businesses.

There is a risk that any merger may not achieve the level of synergies expected, resulting in the parties bearing all the forecast merger costs but not achieving the forecast benefit. The net benefits from synergies must be sufficient to encourage the merger in the first place. The ability of regulators to prematurely remove potential benefits post 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 a greater net loss. Pre-emptive regulatory actions on synergies will discourage merger activity.

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[4] Dr. Kenneth Gordon and Wayne P. Olson: Removing Disincentives: State Regulatory Treatment of Merger Savings, *The Electricity Journal*, 15 October 2006.

[5] Table 1 page 55

[6] Ofgem, *Mergers in the electricity distribution sector, Policy statement*, May 2002 section 3.25.

Conclusion (Synergies)

Multinet submits that that the Commission should adopt an incentive approach to recognising synergies in the GasNet Final Decision This implies waiting until ongoing (net) synergy benefits can be realised and quantified before sharing them with users through a recognised mechanism.

4. WACC Parameters

Multinet responded in depth to the recent Draft Decision by the Essential Services Commission of Victoria in respect of the Gas Access Arrangement Review 2008-2012, and notes that several cost of capital issues raised in that decision are similar to those arising from the Commission's Draft Decision for GasNet[7].

While Multinet welcomes several aspects of the Commission's approach to quantifying the components of GasNet's cost of capital, there are concerns with other aspects. In particular, Multinet considers that:

- there is a persuasive case supporting the retention of a beta value of 1
- there is unambiguous evidence for the existence of absolute bias in nominal Commonwealth Government Securities (CGS).

(a) Equity beta

The Draft Decision states that there is mounting evidence to suggest that an equity beta of 1.0 is conservative. For various reasons cited in its Draft Decision, the Commission has maintained a value of 1.0. At the same time, the Draft Decision states that the ACCC "*may place greater weight on contemporary market evidence in deriving a best estimate of the equity beta under section 8.2(e) of the Code, noting that this may lead to an equity beta of less than 1.0*" (page 85). Multinet is concerned that this statement could imply a value of less than 1.0 in the Final Decision.

In the Victorian Gas Access Arrangement Review, Multinet commissioned an analysis by NERA of an appropriate equity beta for Victorian distributors, and economic consultants CECG and SFG prepared analyses for the gas distributors that was complementary to the NERA work. Multinet submits that this weight of expert opinion strongly supports an equity beta of 1.0, and that it effectively counters a report produced by the Allen Consulting Group for the ESC which may imply a beta of less than 1.0.

(b) Absolute bias

GasNet formally requested the ACCC to consider the evidence from NERA that the nominal and indexed CGS yields are biased downwards. However, the Draft Decision notes that the ACCC does not consider that NERA has to date demonstrated a conclusive case to justify a departure from the accepted approach of using nominal CGS yields to proxy the nominal risk-free rate.

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[7] See Multinet submission dated 29 October 2007 to Essential Services Commission Draft Decision on the 2007 Gas Access Arrangement Review 2008-2012. See also submissions from other infrastructure industry associations and submissions from the Victorian gas distributors (including attachments) on ESC website: http://www.esc.vic.gov.au/public/Energy/Consultations/Gas+Access+Arrangement+Review+2008-2012/Gas+Access+Arrangement+Review+2008-2012.htm

Multinet is concerned that the Draft Decision has not recognised the absolute bias in the CGS market. The absolute bias (attributable to a premium in the yields on nominal CGS) was initially recognised by NERA as discussed in the Commission's Draft Decision. It has since been the subject of further investigation by the consulting firm CECG. CECG[8] have updated research on the absolute bias using the latest market data and Multinet provided this to the ESC.

Conclusion (WACC)

Multinet submits that evidence it has provided to the ESCV confirms that WACC parameters should incorporate an equity beta of 1.0 and allowance for absolute bias in the risk-free rate. Incorporating these values in the Commission's Final Decision for GasNet will reflect, as the Gas Code requires, *'best estimates on a reasonable basis'.*

[8] CECG, *Choosing a proxy for the nominal risk free rate*, October 2007.