United Energy Distribution Pty Limited
ABN 70 064 651 029

Multinet Gas Distribution Partnership
ABN 53 634 214 009

UNITED ENERGY Multinet GAS

United Energy and Multinet Gas
6 Nexus Court
Mulgrave VIC3170
PO Box 449
Mt Waverley VIC 3149
T 03 8846 9900
F 03 8846 9999
www.uemg.com.au

17th November 2014

Our Reference: UE.SU.01

Mr Warwick Anderson
General Manager
Networks Finance and Reporting Branch
Australian Energy Regulator
GPO Box 3131,
Canberra ACT 2601

BY EMAIL TO: Warwick.Anderson@aer.gov.au

Dear Mr Anderson,

SUBMISSION TO THE AER'S CONSULTATION ON THE POST-TAX REVENUE MODEL

Proposed amendment: Electricity distribution network service providers, Post-tax revenue model, (October 2014)

United Energy and Multinet Gas (UE and MG) are pleased to have the opportunity to respond to the AER's consultation on revisions to the post-tax revenue model (PTRM) for distribution. UE and MG recognise that the main purpose of the AER's amendments has been to permit the annual updating of a portfolio average rate of return on debt. The annual updates will take account of the effect of changes in the spot cost of debt[1]. However, various other changes to the model have also been made. UE and MG are generally supportive of the submission from the Energy Networks Association (ENA) [2].

Reductions in regulated revenues from shared assets

A shared asset is one which provides both unregulated services and regulated electricity distribution network services. In 2013, the AER consulted on its method for apportioning the revenues from shared

[1] AER, Better regulation, Rate of return guideline, December 2013, pp. 18–22. There is further explanatory material in AER, Better regulation, Explanatory statement, Rate of return guideline, December 2013, pp. 98–157.

[2] ENA (2014), AER proposed amendments to post-tax revenue models, electricity transmission and distribution, submission by the Energy Networks Association, 17th November 2014.

assets. In the final version of the shared asset guideline, released in November 2013, the AER set out a cost reduction method, an important element of which was that[3]:

> A cost reduction will reduce a service provider's standard control (or prescribed transmission) revenues by 10 per cent of the value of the service provider's expected total unregulated revenues from shared assets in that year.

UE and MG understand that the unregulated revenue relevant to cost reductions is determined by averaging the expected, shared asset unregulated revenues across each regulatory year to which those revenues relate. In addition, a materiality threshold is applicable. The unregulated use of shared assets is deemed to be material when a service provider's annual unregulated revenues from shared assets are expected to be greater than one per cent of the provider's total smoothed annual revenue requirement for that regulatory year[4].

The AER's explanatory statement provides further supporting information[5]:

> Under our method, we will reduce a service provider's regulated revenues from assets providing standard control (or prescribed transmission) services by a fixed 10 per cent of the value of unregulated revenues earned with shared assets. We consider that setting a fixed proportion further enhances transparency and certainty for both service providers and consumers. Alternative approaches, such as making cost reductions of varying proportions depending on the circumstances, would provide less certainty than the guideline approach.

Footnote number 38 in the explanatory statement reports that:

> Asset-related regulated revenues equal a service provider's return on and of capital for its regulatory asset base (RAB). That is, revenues earned through charging for regulated services to compensate service providers for asset depreciation (return of capital) and to provide a rate of return on capital.

Finally, the AER has provided an example in Appendix A of the shared asset guideline document[6]. In the particular example, which is drawn from the AER's draft decision for Energy Australia (from November 2008), the annual revenue requirement for Energy Australia (now Ausgrid) was reported to be $1,284 million in 2009-10. The AER has assumed, in the shared asset guideline, that Energy Australia would earn $30 million in unregulated revenues for 2009-10. The value of unregulated revenues therefore satisfies the materiality threshold of 1% of the annual revenue requirement, (ARR), for 2009-10, although the AER does not make specific reference to a smoothed annual revenue requirement.

Thereafter, the AER has estimated that 10% of shared asset unregulated revenues would deliver an amount equal to $3.0 million. The AER has then subtracted $3.0 million from the ARR, reducing its value to $1,281.8 million. Importantly, however, the AER has not mentioned the particular component of the ARR from which the shared asset revenue should be deducted.

[3] AER, Better Regulation, Shared Asset Guideline, Australian Energy Regulator, November 2013, section 3.1, page 15.

[4] AER, Better Regulation, Shared Asset Guideline, Australian Energy Regulator, November 2013, section 2.3, page 12.

[5] AER, Better Regulation, Explanatory Statement, Shared Asset Guideline, Australian Energy Regulator, November 2013, section 3.3, page 32.

[6] AER, Better Regulation, Shared Asset Guideline, Australian Energy Regulator, November 2013, Appendix A, page 20.

In the new, draft version of the PTRM (October 2014), the AER has created a new input category, in the 'Input' worksheet, which has been labelled "Decrement from shared assets - 6.4.3 (a) (6A)". The user of the model should then enter, in the relevant row, the proposed values of the decrease in revenues from shared assets. For each year, the expected reduction should be entered as a negative number.

In the 'Analysis' worksheet, the AER has dealt with the revenue adjustment for shared assets as though the adjustment were a component of taxable income. This particular method of handling the revenue decline was not foreshadowed in the shared asset guideline. The curtailment of revenue now also has a tax effect, causing a fall in the estimated amount of tax payable. Hence, the benchmark tax allowance would be brought down by an amount that is equal to:

$$\left(\frac{(1-\gamma)t_c}{1-(1-\gamma)t_c}\right) \times (initial\ drop\ in\ shared\ asset\ revenues) \qquad (1)$$

Where:

$\gamma =$ The value of distributed imputation credits, which has been set at 50% in the draft PTRM; and

$t_c =$ The corporate tax rate, which has been recorded as 30%.

The tax effect that is measured by equation (1) is recorded inclusive of the value assigned to imputation credits.

The shared asset guideline did not envisage a reduction in the benchmark tax allowance which would come about as a result of the initial decrement to shared asset revenue. In fact, there is no discussion of tax effects in the shared asset guideline[7]. The AER's current categorisation of shared asset revenues in the PTRM therefore imposes an additional penalty on regulated businesses.

The impact on the net tax allowance of the preliminary deduction of $3 million from regulated revenues is therefore:

$$\left(\frac{(1-0.5)\times 0.3}{1-(1-0.5)\times 0.3}\right) \times (3) = \$0.529 \qquad (2)$$

The diminution in the net tax allowance is equal to $0.529 million.

The AER's objective, as stated in the shared asset guideline, is to achieve a decline in regulated revenues equal to 10% of shared asset unregulated revenues. The AER's intention, therefore, is to bring down regulated revenues which incorporate an estimate of the benchmark cost of paying corporate income tax. Accordingly, the two options that are available to the AER can be described as follows:

1. Take the decrement to regulated revenues, and modify it by multiplying by $(1-(1-\gamma)t_c)$, before entering the resulting value in the 'Input' worksheet of the PTRM. The modified number would be entered in the category of a "Decrement from shared assets - 6.4.3 (a) (6A)"; alternatively
2. Include the reduction in the annual revenue requirement as a final adjustment so that the reduction has no impact on the allowance for taxes that the regulator computes.

[7] AER, Better Regulation, Shared Asset Guideline, Australian Energy Regulator, November 2013.

If the AER were to pursue the first approach, then there would be no immediate requirement to alter the PTRM. However, under the second method, the AER would need to amend the draft PTRM so that the decrement from shared assets would not be construed as being a component of taxable income. If the second method were to be adopted, then the "Decrement from shared assets - 6.4.3 (a) (6A)" would need to be handled in a similar manner to the "Carryover from previous regulatory control period - 6.4.3 (a) (6)". The "carryover from previous regulatory period" does not contribute to taxable income.

- If the first method were to be pursued, then regulated revenues would be curtailed by a deduction from two building block categories in the new PTRM, namely "the EBSS carry-over and other adjustments" and the "net tax allowance". Continuing the previous example, the respective deductions would be \$2.55 million and \$0.45 million. The deduction of \$2.55 million from "the EBSS carry-over and other adjustments" would be worked out as $(1-(1-0.5)\times 0.3)\times \$3=\$2.55$.
- Under the second method, the fall in regulated revenues would be solely concentrated in the category of "the EBSS carry-over and other adjustments", and would be equal to \$3 million.

The interaction between the shared asset guideline and the draft PTRM is explained further in the accompanying memorandum prepared by NERA Economic Consulting[8]. The memo from NERA provides a worked example to show the change in the annual revenue requirement which is consistent with the method presented in the shared asset guideline.

Capital Expenditure Sharing Scheme (CESS)

The explanatory statement for the post-tax revenue model, and the handbook for the PTRM make no reference to the capital expenditure sharing scheme[9]. However, according to the AER's capital expenditure incentive guideline, the CESS penalty or reward should form a separate building block for a network service provider's revenue allowance in a subsequent regulatory control period[10].

UE and MG assume, therefore, that the penalties and/or rewards under the CESS would be measured as a carry-over component in the PTRM. At present, the draft PTRM has an input category which has been labelled as "Carryover from previous regulatory contol period - 6.4.3 (a) (6)". UE and MG note, however, that the capital expenditure sharing scheme is mentioned separately, under clause 6.4.3 (a) (5) of the National Electricity Rules. Therefore, the values of the carry-overs from the CESS could be entered into other rows in the 'Input' worksheet. Other incentive schemes may also give rise to carry-overs (either positive or negative).

UE suggests that if, at a future date, any unforeseen complications arise as a result of the interaction between the CESS and the PTRM, then the AER should take steps to either correct the PTRM or amend the Capital Expenditure Incentive Guideline.

---

[8] NERA, Shared Assets and the PTRM, Memorandum from Simon Wheatley, 13th November 2014.

[9] AER, Explanatory Statement, Proposed amendment, Electricity transmission and distribution network service providers, Post-tax revenue models (version 3), Australian Energy Regulator, 3rd October 2014.

Proposed amendment, Electricity distribution network service providers, post-tax revenue model handbook, Australian Energy Regulator, October 2014.

[10] AER, Better Regulation, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, Australian Energy Regulator, November 2013, section 2.3.4, page 12.

Equity raising costs – determining the equity needs of a regulated business

The AER has not undertaken a comprehensive review of its method for calculating equity raising costs. In the draft PTRM for electricity distribution network service providers, the new worksheet for equity raising costs is very similar to the corresponding worksheet in the previous version of the PTRM (June 2009)[11].

There is a potential inconsistency regarding the incorporation of carry-overs in the new, draft version of the PTRM[12]. According to a cell comment in cell F24 of the 'Equity raising cost' worksheet, the carry-over component of the efficiency benefits sharing scheme (EBSS) has been excluded from the "revenue adjustments". The cell comment is correct because the operating expenditure variable (row 22) has been measured exclusive of the carry-over from the EBSS[13]. However, other carry-over components have been factored into the "revenue adjustments". The other carry-over components include revenue increments or decrements arising from the application of a control mechanism in the previous regulatory period, and could also encompass carry-overs which result from the application of the capital expenditure sharing scheme (CESS). A positive carry-over calculated under the CESS would boost the retained cash flows, and thereby lessen the requirement to raise new funds from equity.

The AER should take care to ensure that the carry-overs from incentive schemes such as the CESS and the demand management and embedded generation connection incentive scheme (DMEGCIS) are dealt with in a manner which is consistent with the treatment of carry-overs under the EBSS. The carry forward (building block) amounts from other incentive schemes should not have the effect of bolstering or diminishing the estimate of the retained cash flows, which, in turn is used in the assessment of the requirement for new equity.

The AER has maintained its previous values for dividend re-investment plan costs, subsequent equity raising costs, and dividend re-investment plan take-up rates. Dividend re-investment plan expenses have been worked out, using the benchmark "DRP" cost of 1% as applied to the dividend reinvestment plan requirement, while the external equity raising cost is now only computed for the difference between the equity requirement and dividend reinvestment. The benchmark seasoned equity offering (SEO) raising cost is still set at 3%.

The following variables should therefore be subject to review:

- The assumption of a 1% cost for a dividend reinvestment plan
- The size of the direct cost allowance of 3% for SEOs
- The rate at which dividends are assumed to be re-invested (currently set at 30%).

The 'Equity raising cost' worksheet makes use of net capital expenditure figures, i.e. capital expenditure minus the level of customer contributions. Since net capital spending is invariably lower than gross

---

[11] AER, Appendix B – Amended distribution post-tax revenue model (PTRM) – 19th June 2009, Australian Energy Regulator.

[12] AER, Proposed amended distribution post-tax revenue model (PTRM) – October 2014, Australian Energy Regulator.

[13] The carry forward components under the efficiency carry-over scheme were also exempted from operating expenditure in the 'Equity Raising' worksheet of the June 2009 version of the PTRM.

capital spending, the requirement to raise new equity will be shown as being less than it would otherwise be.

An offsetting factor, however, is that customer contributions affect the estimate of taxable income in the PTRM (essentially pushing it up). Dividends are then computed by grossing up the estimate of tax payable. The payment of dividends to shareholders creates the need for new equity to be raised. The taxation of customer contributions generates franking credits, the presence of which gives rise to a second round need for dividends.

A review of the framework for equity raising costs should consider, *inter alia*:

- The additional dividend distributions that need to be made so that shareholders can realise the benefits from gamma.
- The complementary capital expenditure that might be required to match a certain level of customer contributions.

Review of the draft PTRM by spread sheet consultants, 'Sumproduct'

UE and MG commissioned a firm of Excel specialists, 'Sumproduct', to perform a review of the draft PTRM for distribution. The review was undertaken so that 'Sumproduct' could detect formulaic errors and other inconsistencies in the model that had been prepared by the AER. The report from 'Sumproduct', which is in the form of an Excel worksheet, is appended to this submission. UE and MG believe that the report from 'Sumproduct' will assist the AER in its task of checking the model, and ensuring its integrity. 'Sumproduct' has followed a typology of mistakes, whereby the number '1' in column F denotes an error, number '2' is a potential error, number '3' is a best practice recommendation, and 'queries' are identified as such.

Final comment

UE and MG have identified that the PTRM handbook contains minor typographical errors which should be rectified[14]. I urge you or your staff to make contact with me, by telephone on (03) 8846 9854, if you have any queries about this submission.

Yours sincerely,

Jeremy Rothfield
Network Regulation and Compliance Manager

[14] AER, Proposed amended distribution post-tax revenue model (PTRM) – October 2014, Australian Energy Regulator.