

# Submission to the Essential Services Commission

## Re: Electricity Distribution Price Review 2006 – 2010 Draft Decision

### Relevant Costs (Related Party Transactions)

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### 1 Introduction

This report outlines United Energy Distribution (“UED”)’s submissions in response to the Commission’s Draft Decision relating to “Relevant Costs” (Section 5 of the Draft Decision). In particular, these submissions put UED’s position relating to the:

- Treatment of costs of related party transactions, in particular the costs to UED of the provision of services by Alinta Network Services (“ANS”)<sup>1</sup>;
- Establishment of operating and maintenance expenditure benchmarks for the period 2006-2010; and
- Changes in the Commission’s approach with regard to establishing operating and maintenance expenditure benchmarks and the efficiency carryover mechanism.

Since the Draft Decision, the Commission has expressed new views in a letter dated 20 July 2005 that relate to the assessment of relevant costs. These views are inconsistent with those in the Draft Decision. These submissions also outline these new views and UED’s response to them (in Section 3.2).

In support of the submissions made here, UED intends to supplement this response with the evidence (including from experts) identified in these submissions. UED will tender this evidence to the Commission no later than Friday, 2 September 2005.

UED has also already responded separately on some of the other key issues associated with the estimation of relevant costs (including various errors in the Commission’s interpretation of UED’s regulatory accounting information and the adjustment made for excluded services).

This response should be read in conjunction with two previous submissions made by UED that relate to the assessment of relevant costs.<sup>2</sup>

#### 1.1 Outline of these Submissions

The structure of the remainder of these submissions is as follows:

- Section 2 – related party costs – UED rejects the Commission’s view related party costs will only be taken to be efficient if “market tested” by open tender, and submits that UED’s reported costs are efficient and should be taken to be so without a tender process because they have been market tested in another way;

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<sup>1</sup> These submissions use the language of “related party” for convenience of expression only because that is the language of the Commission. No concession is made that the relationship between UED and ANS is one of related parties.

<sup>2</sup> UED, United Energy Distribution’s Service Acquisition, April 2005; and UED, United Energy Distribution’s Service Acquisition: Passing Efficiency Gains to Customers, May 2005.



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- Section 3 – changes in approach - in this section, UED submits that it is unacceptable for the Commission to propose to change its approach to establishing operating and maintenance expenditure benchmarks because UED will unjustifiably suffer from the change; and
- Section 4 – precedents and primary objective – in this section, UED demonstrates that the ESC has relied on inappropriate precedents to support these proposed changes and is misinterpreting its primary objective in the process; and
- Section 5 – other flaws - identifies the other factual flaws in the Commission's analysis of relevant costs.

There are three appendices. Appendix A outlines the business structure within which UED operates. Appendix B outlines the history of the regulator's approach to related party transactions including defining and then redefining market testing. Appendix C provides some background relevant to the interpretation of the Commission's primary objective.



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### 2 UED's Related Party Costs can be Inferred to be Efficient

Section 2 demonstrates that:

- UED's related party costs being fees charged by its operating service provider, ANS, are and for regulatory purposes can be inferred to be efficient, because they have been market tested; and
- UED's related party costs being fees charged by UEDH for corporate services are and for regulatory purposes can be inferred to be efficient, because they have been market tested.

UED has made two previous submissions that relate to the services provided by ANS and UEDH, how these arrangements have been market tested and how the benefits of efficiency gains are shared with customers.<sup>3</sup> The key points of those submissions are repeated here and remain uncontested by the Commission. Appendix A also summarises the commercial structure within which UED operates, and within which its agreement with ANS operates.

The substance of the submission relating to the service arrangements with ANS is that the service arrangements has been market tested because they came into being through a commercial negotiation of the principal service contract between the service provider (Alinta), which owns 34% of UED, and the other owner of UED (DUET), which owns 66% of UED. DUET was in effect the 'reality check' that the service contract was on commercial terms, because DUET had and continues to have no commercial, equity, or other interest in any arrangement which would have ANS deriving fees which are not commercially based. It follows that UED's costs in this regard have been market tested and can be inferred to be efficient for regulatory purposes.

Even though there is a partial common ownership of ANS and UED, the DUET equity interest in UED ensured that the negotiation of the services agreement between ANS and UED was on an arms' length bona fide basis. Because of this, the fees payable by UED under it are not capable of being described as 'cost inefficient' and it is simply unreasonable to conclude that cost inefficiencies remain despite these arms' length negotiations.

In support of UED's view that its service agreement with ANS has been market tested by means of the above matters, on or before 2 September 2005 it will tender relevant evidence of the circumstances in which the services agreement was entered into.

This will include:

- Witness statements from relevant parties involved in the transaction in July 2003 under which the UED interests of Aquila, Inc were acquired by Alinta Limited and under which the provision of UED's service needs were contracted to ANS. The

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<sup>3</sup> UED, United Energy Distribution's Service Acquisition, April 2005; and UED, United Energy Distribution's Service Acquisition: Passing Efficiency Gains to Customers, May 2005.



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substance of the evidence will be that those contractual arrangements were negotiated by an independent stakeholder in the transaction, DUET, which owns 66% of UED, and that entity ensured (to protect its own interests and not those of the service provider) that the provision of the services was on a competitive and commercial basis. Accordingly, for all relevant purposes the services agreement was market tested;

- UED will also tender into evidence expert independent economic opinion on what market testing means, the types of activity it may include and how it may be conducted (including those in which UED's commercial structure evolved);
- UED will also tender into evidence expert independent commercial opinion on whether UED's structure is consistent with the sorts of structures that are observed in the market place for similar assets, regardless of their regulatory status. In addition, expert opinion will state that, in this context, open competitive tenders are not the only form of market testing.

The substance of the submission relating to the service arrangements with UEDH is that the arrangements have been market tested through independent benchmarking. Again, on or before 2 September 2005 UED will tender relevant evidence of the circumstances in which these services arrangements were entered into.

### 2.1 UED's Service Acquisition from ANS has been Market Tested

#### 2.1.1 The Transaction

As mentioned above, UED's service agreement with ANS was one of many of the agreements comprising a restructure of the UED business in July 2003. The ANS service agreement in respect of UED was entered into as part of a larger transaction under which:

- AMP Henderson, an investment fund based in Australia, would establish a diversified utilities energy trust to be known as DUET (established June 2003);
- DUET would acquire a 66% interest in UED;
- Alinta Ltd would acquire a 34% interest in UED; and
- Part of the DUET and Alinta interests to be acquired in UED referred to above would be acquired from the public, requiring a Court approved scheme of arrangement (the Supreme Court of Victoria).

As part of the transaction, Alinta and AMP Henderson (DUET) formed United Energy Distribution Holdings Pty Ltd (UEDH) to acquire United Energy Limited. The interests in UED of DUET and Alinta referred to above are held through UEDH.

At the same time, July 2003, DUET and Alinta purchased Multinet (79.9% held by DUET, 20.1% held by Alinta). DUET also acquired a 25.9% interest in AlintaGas Networks. Alinta then entered into long term service agreements for the operation of



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Multinet and AlintaGas Networks, just as it had done for the UED business. DUET was satisfied commercially that Alinta was the appropriate counterparty to these service agreements as Alinta was a capable operator able to manage operational risks across the UED, Multinet and AlintaGas Network businesses.

During that transaction all parties had a commercial incentive to ensure that all the arrangements were reasonable, efficient and optimal. In particular, the:

- Ownership and commercial arrangements meant that the key parties have different incentives consistent with the efficient provision of services to UED;
- Larger transaction of which the service agreement was part created the necessary competitive pressures and commercial disciplines to enable market based arrangements to be introduced; and
- Extensive commercial negotiation and interaction at the time of the transaction ensured that the Shareholding groups of the four independent entities, namely UEL minorities, Aquila, DUET, Alinta maximised the value they would obtain from the transaction. That value was maximised for all parties by ensuring UED's ongoing value was itself maximised from commercially struck arrangements which would not invite regulatory intrusion.

The service arrangement has been market tested because it came into being through commercial negotiation of the principal service contract between the service provider (Alinta), which owns 34% of UED, and the other owner of UED (DUET), which owns 66% of UED. DUET was a countervailing constraint on any potential uneconomic behaviour of ANS.

### **2.1.2 Independent Scrutiny**

In relation to UED, these transactions were approved by the stakeholders of UEL themselves and by the Supreme Court of Victoria under a scheme of arrangement which authorised the relevant transactions.

Under Section 640 of the Corporations Act an independent expert's report is required to be included in a Target's Statement, where the bidder is connected with the target. As the independent directors noted:

"To further assist shareholders in reaching their decision, we commissioned an Independent Expert, Deloitte Corporate Finance, to consider the \$3.15 offer being made under the proposed Scheme. Deloitte concluded that in the absence of a higher offer the Scheme is fair and reasonable and in the best interest of United Energy shareholders other than Power Partnership."

The Independent Expert's report valued the company as a whole and found no difference in the value of the company for those who would have an ongoing interest from those who were exiting it. This would not have been the case if significant value shifting were occurring.



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The transaction was partly debt financed and all of the relevant transaction documents, including the ANS service agreement, were also required to be approved by the financiers prior to completion of the transaction.

UED's audited regulatory accounts for 2004 (lodged in April 2005) state in regard to the provision of services by ANS that:

"The operating services fee is paid to Alinta Network Services Pty Ltd in accordance with the Operating Services Agreement dated July 2003 between United Energy Limited (now United Energy Distribution Pty Ltd), Alinta Network Services Pty Ltd and United Energy Distribution Holdings Pty Ltd. The services included in the fee are operating and maintenance services. This contract was negotiated prior to 23 July 2003 by parties that were then unrelated. The operating services fee represents a market tested fee."

The regulatory accounts are audited by Ernst and Young consistent with the terms of a tripartite agreement between it, UED and the Commission, and the Commission has used this information for the purposes of its comparative performance reporting.

### 2.1.3 'Open Tender' not Possible for the Service Agreement

The provision of services by ANS under the services agreement could not have been put out to 'open tender'; this was commercially impossible in the context of the overall transaction with its significant competing stakeholder interests and the fundamental requirement of DUET (owned by AMP Henderson), on the one hand, that the preferred operator hold a substantial equity interest and at the same time Alinta, on the other hand, requiring that its appointment as operator carry with it a substantial equity interest in the asset being managed. Debt financiers also required that the operator have some equity in the underlying assets.

### 2.1.4 Further Evidence

Evidence will be tendered to the Commission on these aspects including the competitive tensions which gave rise to the service agreement between Alinta and UED.

## 2.2 UED's Ownership Structure Results in a Commercial Operatorship Regime

The way ANS provides services to UED is driven by commercial imperatives arising from different stakeholder interests. Unlike some of the other distributors, it is not acquiring services from a 100% owned subsidiary of the owner. Rather, the services are being provided by a subsidiary of a minority owner (Alinta) under an agreement which has been approved by the major owner (DUET), which is independent from the minority. The majority stake is held by a single entity who controls UED.

This difference, which is fundamental to an understanding of the commerciality of the services agreement between UED and ANS, is illustrated in the table below.

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**Table 2.1 – UED’s Understanding of the Ownership and Operational Features of the Distributors**

Distributor	Asset owner	Major service provider	Relationship with owner	Term
AGLE	AGL	Agility	100% owned by Asset Owner	In perpetuity
CitiPower	CKI	Powercor	100% owned by Asset Owner	In perpetuity
Powercor	CKI	Internal	N/A	N/A
SPI AusNet	SPI	Tenix	No ownership interest by Asset Owner	Not known
UED	DUET (66%)/ Alinta (34%)	ANS	34% owned by Asset Owner	3+5 years, with right to match thereafter

Whilst the Commission continues to rely on excerpts from the Productivity Commission Report on its Review into the Gas Access Regime to support its approach (see Draft Decision at page 162 -3) it does not refer to the fact that the relevance of the parent company’s ownership of both the service provider and related party was recognised by the Productivity Commission in that Report. The Productivity Commission said:

“...the larger the parent company’s share of ownership in both entities, the greater the incentives to engage in inappropriate transfer pricing.”<sup>4</sup>

Under UED’s business structure:

- DUET has no incentive to pay above market prices to the service provider for the services provided to UED. It has a positive commercial imperative to ensure its equity returns are optimised and therefore it does not permit the service provider to take a portion of the equity returns which would have gone to DUET by charging uncommercial fees. DUET derives 66 cents in every dollar of earnings from the UED business. It follows that an uncommercial service arrangement if it existed would damage that flow of earnings to DUET as the majority stakeholder of UED. DUET would not and has not permitted this. Evidence will be tendered to this effect;
- It is in DUET’s interests to pay fees to its service provider which are the result of extensive commercial negotiations which recognise DUET’s long term commercial interests as the major owner of the assets and which optimise its return on its investment over time while maintaining the integrity of the assets; and

<sup>4</sup> Productivity Commission 2004, *Review of the Gas Access Regime*, Report no.31, Canberra at page 459.

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- The stakeholders in UED are independent of each other: Alinta does not control UED and DUET does not control ANS or Alinta. Further, the directors of UED who hold directorships in Alinta are prohibited from voting on the service agreement between the parties.

It is submitted that the UED ownership structure, with the major ownership held by DUET which is independent of the ownership interests of the operator, ANS, creates the necessary commercial tension between the parties to enable shareholder returns of both parties to be commercially determined. In other words, the preferred structure provided an appropriate balance between aligning the broad long term interests of the parties and creating commercial tension in the shorter term operating relationship between them. It was preferred to other commercial structures (eg. an agreement with a service provider with no equity interest, or some other form of arrangement).

### 2.3 The Commission must Assess the Reasonableness of UED's Costs, not the Costs of its Service Provider (ANS)

The appropriate cost inquiry relates to UED's costs of retaining ANS as a service provider.

If it is proper for the Commission to move away from the representations regarding the "long term" made in 2000 (which UED does not accept), in keeping with representations made by the Commission during this review process, the Commission is obliged to consider whether or not UED's service arrangements have been market tested.

It is ill-conceived to examine ANS's costs. Any step by the Commission to examine the costs of UED's major service provider (ANS) is flawed as ANS is not the licensed entity. The Commission's obligation under the *Essential Services Commission Act* is, according to the Commission, to ensure that the costs of UED as the regulated entity are reasonable and efficient. There are a variety of ways in which this might be achieved but these do not include an examination of third party costs.

Moreover, if the Commission's enquiry is directed to any margin that may be included in the costs charged by ANS, UED submits that it is irrelevant whether or not ANS's charges include such a margin and, if they do, the magnitude of any margin.

### 2.4 UED's Corporate Costs have been Independently Benchmarked

As UED's submission of April 2005 shows, the costs of the provision of corporate services to UED by UEDH have been market tested via independent benchmarking.

This is borne out by UED's audited regulatory accounts for 2004 (lodged in April 2005) which state in regard to the provision of corporate services that:

"The management fee is payable to United Energy Distribution Holdings Pty Ltd and relates to services for corporate and other services not included in the Operating Services Agreement referred to in (b – additional related parties). These charges have been determined through a commercial arms length process



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designed to ensure that they are no more favourable than if the transactions were to have occurred between parties that were not related, and as such is equivalent to market testing.”

The regulatory accounts are audited by Ernst and Young consistent with the terms of a tripartite agreement between it, UED and the Commission, and the Commission has used this information for the purposes of its comparative performance reporting.

### 3 Changes to Setting Operating and Maintenance Expenditure Benchmarks

Section 3:

- Notes that the Commission is proposing to change its approach to establishing operating and maintenance expenditure benchmarks and how it is proposing to do so; and
- Sets out how this will damage UED if the Final Determination confirms this change.

In particular, the Commission is proposing to:

- Change its approach to the “long term mechanism” introduced in the 2001 EDPD; and
- Retrospectively introduce requirements for market testing, which it appears to be formulating as it goes along both in terms of defining and applying the concept.

#### 3.1 The Long Term Mechanism

The regulator went to considerable lengths in the 2001 EDPD to outline how it would establish operating and maintenance expenditure benchmarks in the following period and how it would reward efficiency gains. This approach involved separating between the:

- Transitional mechanism to apply in the 1995-2000 regulatory period; and
- Long term mechanism to apply thereafter.

The long term mechanism was meant to rely on using reported costs to establish the benchmarks in the next period and the efficiency carryover amounts. For example, the regulator stated that:

“In setting benchmarks for the following regulatory period, the Office’s presumption will be as follows:

- For operating expenditure, the benchmark for the first year of the next regulatory period (year t) is set equal to the assumed outcome for year t-1.”<sup>5</sup>

The 2001 EDPD also stated in regard to the long term mechanism that it:

“...has been designed with the objective of making it transparent, easy to administer and replicable from one regulatory period to the next.”<sup>6</sup>

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<sup>5</sup> ORG, 2001 EDPD: Volume 1 Statement of Purpose and Reasons, September 2000, page 85.

<sup>6</sup> Ibid., page 87.

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And that:

“The Office considers that a degree of certainty about the Office’s approach to adopting a **long term** efficiency carryover mechanism will provide more effective incentives for encouraging the efficient behaviour described above. Whilst the Office cannot now bind the future exercise of statutory powers, it considers that a **long-term** approach to determining the efficiency carryover (that is, spanning more than one regulatory decision-making period) is consistent with the statutory objectives the Office must meet (our emphasis).”<sup>7</sup>

As recently as the Guidance Paper, the Commission appeared to remain committed to this approach. It stated:

“As foreshadowed in the 2001-05 price review, the Commission considers that it can rely on the incentive properties of the CPI-X framework, incorporating the efficiency carryover mechanism, to provide incentives for distributors to achieve efficiencies in opex. The aim of including an efficiency carryover mechanism in the 2001-05 price review was to provide distributors with a stronger incentive to achieve efficiencies. A corollary of this is that distributors would be expected to reveal their efficient level of costs, because they are directly rewarded for outperforming the expenditure forecasts established at the last price review. Hence, the Commission can infer that reported actual costs are efficient. Where the scope of activities is unchanged, this inferential approach reduces the need for reliance on external benchmarking processes to assess the efficiency of cost forecasts put forward by the distributors (our emphasis).”<sup>8</sup>

In its Draft Decision, the Commission walks away from its long term mechanism by proposing to adjust reported costs where it believes they do not reflect efficient costs. It states:

“The expenditure data presented in Table 5.1 reflects adjustments to the distributors’ regulatory accounts to obtain an estimate of the efficient costs of providing distribution services and to ensure consistency for purposes of comparison and analysis.”<sup>9</sup>

### Summary

The regulator’s “long term” approach to setting expenditure benchmarks and rewarding efficiency gains will, on the basis of the Draft Decision, not last one regulatory period. As Section 4.2.1 highlights, it is difficult to reconcile this view of what the long term means in respect of the long term mechanism, with the Commission’s definition of the long term in the Draft Decision.

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<sup>7</sup> ORG, 2001 EDPD: Volume 1 Statement of Purpose and Reasons, September 2000, page 84.

<sup>8</sup> ESC, EDPR 2006-10: Final Framework and Approach: Volume 1, Guidance Paper, June 2004, page 66.

<sup>9</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, p. 164

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### 3.2 Market Testing

The most significant area in which the Commission abrogates the long term mechanism is in relation to the related party transactions dealt with in section 2 of these submissions.

The Commission's retrospective introduction of excessively stringent "market testing" is reflective of this, as is its inability to explain its position in this respect. This highlights the difficulty UED has had in participating in the consultation on this issue.

Appendix B summarises the background in respect of the debate that has emerged on related party transactions and market testing in particular. It highlights that the Commission has only recently defined what it regards as "market testing". Indeed, the test has emerged:

- One and half years after the words were inserted into the regulatory accounting guidelines; and
- One year after the commencement of the price review process.

One of the key issues has been the extent to which evidence of market testing would allow the Commission to infer that reported costs are efficient. For example:

- On 30 January 2004 the Commission issued revised regulatory accounting guidelines.<sup>10</sup> In respect of related party transactions, it introduced (at section 5.24.1) the following requirement for market testing:

“...a description of how the transaction was arrived at, including any market testing undertaken.

Market testing was not a defined term in the guidelines, nor was it defined or discussed in any of the Commission's consultation papers in respect of the revision of the regulatory accounting guidelines. The guidelines also only refer to "any" market testing, which suggests that the requirement for market testing is not mandatory.

On the 15 July 2004 the Commission wrote (as part of its review of regulatory accounting statements for 2000-03) to UED stating:

“Please provide any further evidence you may have to indicate that the related party contracts have been market tested. In the absence of such information, the Commission will require United Energy to demonstrate that these contracts reflect efficient costs.”

On the 24 March 2005 the Commission stated in its Position Paper that:

“Where appropriate market-testing has not been undertaken within a competitive market, the distributor will continue to be required to report actual costs incurred by the related party.”<sup>11</sup>

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<sup>10</sup> ESC, Electricity Industry Guideline No.3: Regulatory Information Requirements, January 2004.

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In respect of the process, the Commission stated that:

“The Commission is awaiting further information from Powercor and United Energy. United Energy believes that it will be able to demonstrate that its related party contracts have been market-tested.”<sup>12</sup>

On the 22 June 2005 the Commission stated in its Draft Decision that:

“The Commission acknowledges that evidence of effective market testing of the value of related party contracts would be a relevant consideration in deciding whether to seek actual costs or to accept the contract price. However, the only evidence the Commission considers acceptable for this purpose would be evidence that the related party won the service contract in a competitive arm’s length tender process.”<sup>13</sup>

- Post the Draft Decision (on 20 July 2005), however, the Commission wrote to UED has part of an information request in respect of certain costs. It stated that:

“While regulatory accounts filed by UED have referred to it and Alinta as related parties, whether or not they are actually related parties (as defined in Guideline No. 3 or in any other way) is not of itself conclusive of the determination on the part of the Commission to seek information of the type set out above. In this regard, the Commission notes that section 37 of the *Essential Services Commission Act 2001* is itself not confined to related parties but enables the Commission to seek documents from any person. Equally, whether or not any such contract has been “market tested” (however that may be defined) is not a precondition to the Commission seeking information of this type – although the Commission is not to be taken to be satisfied that the agreement between UED and the Alinta subsidiary has in fact been negotiated in circumstances that would assure the Commission that the resultant price and terms are what would be expected in a competitive process. The point is that, for the reasons given above, the Commission of the view that it needs to assess whether the services provided by the Alinta group to UED are being provided at a reasonable cost and are properly attributable to the efficient provision of prescribed distribution services.”<sup>14</sup>

The Commission now appears to be arguing that whether service acquisition has been market tested or not is of no relevance in determining whether it should seek actual costs. Moreover, its approach is without reference to its own definition of market testing and provides no confirmation that this concept is of relevance when assessing whether it needs to use the cost information sought. If it is proper for the Commission to move away from the representations regarding the “long term” made in 2000 (which UED does not accept), in keeping with representations made by the Commission

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<sup>11</sup> ESC, EDPR 2006-10: Position Paper, March 2005, page 29.

<sup>12</sup> SC, EDPR 2006-10: Position Paper, March 2005, page 29.

<sup>13</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, p. 164.

<sup>14</sup> Ibid., page 3.

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during this review process, the Commission is obliged to consider whether or not UED's service arrangements have been market tested.

The Commission also contends that if open tendering is not relied upon, reported costs cannot be inferred to be efficient. Instead, it presumes that the contractual arrangements between UED and its service providers are not commercial and therefore that the costs are inefficient, subject to receiving actual cost information that dispels this presumption (without indicating what information would dispel this presumption). For the reasons set out in section 2, this presumption is flawed as the service provider agreement between UED and ANS was negotiated on a commercial basis between parties with different commercial interests.

The corollary of the Commission maintaining these views in its Final Determination is that it will necessarily need to remove the requirements for market testing and related party transactions from the regulatory accounting guidelines. Under the Commission's new proposed approach, these issues will have no bearing on whether it requires the parties to produce the actual costs of the service providers that have contracts with the licensed entity. That position is unsustainable.

It is worth noting this potential position is contradicted in the Commission's earlier Position Paper. It states:

"The Commission's review of the distributors' regulatory accounting statements has identified the need to revise the Commission's Regulatory Accounting Guideline. In conjunction with this review, the Commission proposes to provide clearer guidance in relation to related party contracts. This will include a clearer definition of what constitutes market-testing and the policies and procedures required to be implemented by the distributor to demonstrate that appropriate market-testing has been undertaken within a competitive environment."<sup>15</sup>

The Draft Decision also discusses the apparent failings of the current regulatory accounting guidelines (which it recently reviewed) in respect of the same issues in some detail.

It is to be noted that in the 2001 EDPD, the regulator:

- Was careful to ensure it did not make retrospective adjustments in its Final Determination. Making retrospective decisions is indicative of rate of return regulation, which is expressly prohibited under the Tariff Order;<sup>16</sup> and
- Used a transitional mechanism to reward efficiency gains and set expenditure benchmarks, after it failed to establish more general rules on the treatment of efficiency gains before the end of the first regulatory period. It adopted this approach on that occasion because the:

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<sup>15</sup> ESC, EDPR 2006-10: Position Paper, March 2005, page 29.

<sup>16</sup> 2001 VSC 153, Para, 198. The Victorian Supreme Court endorsed this view in the TXU case.

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“...mechanism adopted cannot now influence incentives and behaviour during the first regulatory period.”<sup>17</sup>

The same rationale applies to the Commission’s proposal to retrospectively define market testing (ie. businesses cannot renege on their contractual commitments). Consistency alone warrants a similar approach to market testing, assuming the Commission is to pursue its current approach.

### ***3.2.1 The Definition of Market Testing is Unnecessarily Restrictive***

The Commission now considers that market testing can only comprise an open competitive tender. The evidence the Commission provides to support its view is that:

“Other regulators (for example, including Ofgem and the Australian Taxation Office) also adopt this approach to market testing of related party contracts. Other approaches, for example benchmarking, would not be accepted by the Commission as providing acceptable evidence of market testing.”<sup>18</sup>

It is not apparent what “approach” the Commission claims the Australian Taxation Office and Ofgem support, and it provides no evidentiary support for its assertions.

Putting aside whether these comparisons or precedents can be relied upon, the Commission’s assertions appear to be incorrect and misleading respectively.

In the case of the Australian Taxation Office (“ATO”), the Commission’s assertion is incorrect. The ATO relies heavily on benchmarking to assess reasonable taxation payments for intercompany transactions, as UED’s previous submission on market testing illustrates.<sup>19</sup> It does not require related parties to market test their intercompany transactions (via open, competitive tender) before the fact. Presumably this is because such approach would be impractical; for the same reasons, it is impractical for the electricity distributors to do so and ignores the commercial reality of these arrangements in any event.

In the case of Ofgem, the Commission’s assertion appears to be rather misleading.

Ofgem uses a different approach to treat the benefits associated with integration (ie. it does not use the efficiency carryover mechanism - which the Commission has largely copied – for this purpose). Indeed, it has provides specific guidance on how it will treat mergers and has specific mechanisms to share the benefits with customers. In other words, it provides businesses with certainty about how the benefits of integration are treated. It is not applying a retrospective definition of market testing to appropriate those benefits.

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<sup>17</sup> ORG, 2001 EDPD, Re-Determination, December 2000, page XXIV

<sup>18</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, p. 164.

<sup>19</sup> UED, United Energy Distribution’s Service Acquisition, April 2005.



## Relevant Costs (Related Party Transactions)

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Putting these precedents aside, the Commission has not provided a regulatory or any other basis for the narrow definition of “market testing” it has adopted.

UED has sought to understand from the Commission the basis upon which it has adopted its market testing approach but to date has not been provided with any explanation of that basis. Because of this, UED is now undertaking a number of steps to demonstrate that for all relevant purposes the service agreement with ANS has relevantly been market tested. Section 2 outlines those steps.

It is submitted that open market tendering may be a relevant market test in one particular context, but should not in any circumstances be an exhaustive test, and moreover, should not be the test applied to assess cost efficiencies where an open market tender is incapable of being conducted. This is the position under the service agreement between UED and ANS. However, for the reasons outlined earlier, an appropriate market test exists in the form of the protection by DUET of its equity rate of return from its interest in UED so that Alinta as a service provider is only ever paid at market rates.

### 3.2.2 Summary

The Commission’s process has over the last eighteen months therefore gone from:

- Introducing a requirement that, in respect of related party transactions, the distributors merely report any market testing undertaken; to
- Requiring that all related party transactions be market tested (or it will want to see the actual cost of the service provider); to
- Defining market testing to mean only an open competitive tender (or it will want to see the actual costs of the service provider); to
- Seeking to apply that definition of market testing retrospectively (ie. to arrangements that have already been entered into); to
- Appearing to argue that the relationship between the parties and market testing are irrelevant to it seeking the actual costs of the service provider and distancing itself from applying the market testing concept in ensuring that services *“are being provided at a reasonable cost are properly attributable to the efficient provision of prescribed distribution services”*.

This regulatory uncertainty is unhelpful at the least and substantially erodes the confidence of infrastructure investors in the long term, which can only harm customers of distribution businesses over time.

### 3.3 The Commission’s Change in Position will Damage UED and ANS

The Commission’s changes in position in respect of how it proposes to establish operating and maintenance expenditure benchmarks, and inappropriately defining and applying market testing, will damage UED, if not corrected in the Final Determination.



## Relevant Costs (Related Party Transactions)

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UED has already entered into arrangements with service providers, as part of the much larger and broader transaction summarised in section 2.1 above. It entered into these arrangements on the basis of reasonable expectations about the development of the regulatory regime, including the efforts of the Commission to provide certainty about the long term regulatory regime. For example, UED did not enter into these arrangements in the expectation that the Commission would retrospectively introduce a requirement for market testing in respect of arrangements that had already been entered into.

If the Commission proceeds with its current approach, it will distort the commercial relationship between the parties to their detriment. That distortion will be significant and may require a fundamental re-assessment of the commercial arrangements struck between two independent listed entities with knock on effects to other stakeholders including equity providers and financiers. There is no regulatory or other basis for such intrusive conduct by the Commission in disturbing independent bona fide commercial arrangements.



## Relevant Costs (Related Party Transactions)

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### 4 Other Flaws in the Commission's Approach and Analysis

This section illustrates that in proposing to change its approach to establishing operating cost benchmarks, the Commission:

- Has relied on inappropriate precedents to support these changes; and
- Is misinterpreting its primary objective.

The Draft Decision contains a number of errors in the Commission's approach and analysis. In particular, the Commission:

- Misapplies the Appeal Panel Reasons for Decision in 2000;
- Misinterprets the primary objective; and
- Has failed to have regard to UED's submissions.

The Commission engages in a reasonably lengthy discussion to justify why it believes it can make "adjustments" to the distributors' reported costs to establish the efficient base operating expenditure benchmarks for the next period and in calculating the efficiency carryover amounts. In particular, it relies on the findings of the Appeal Panel in the 2001 EDPD.

This, together with the Commission apparently abandoning the "market test" as a threshold issue for the seeking of actual costs in relation to related party contracts in its letter of 20 July 2005, highlights the difficulty UED has had in participating in the consultation on this issue.

#### 4.1 Misapplication of the Appeal Panel Reasons for Decision in 2000

The Commission relies on the Appeal Panel's findings to support its ability to adjust the regulatory accounts. Yet the Commission opposed the making of any such adjustments either to the benchmarks or the reported costs in the 2001 EDPD.

But, more importantly, it is critical to closely examine the circumstances of the appeal and the actual findings of the Appeal Panel as doing so establishes that the Commission is wrong in its presentation of the appeal outcomes and so, it follows, wrong in relying upon it as the Commission seeks to do in the Draft Decision. It is also necessary to distinguish between what the Appeal Panel actually said and what the Commission did in response in its Re-Determination. Just because the Commission responded to the Appeal Panel's findings in a particular way in its Re-Determination, it does not follow that response has been endorsed by the Appeal Panel as correct.

A close examination shows:

- The issue in the 2001 EDPD was not about **adjusting** reported costs. Indeed, the Commission argued it relied on reported costs. The Appeal Panel merely found

## Relevant Costs (Related Party Transactions)

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that it had relied on reported costs that were inconsistent. The decision was manifestly not about the regulator's ability or otherwise to adjust the regulatory accounts. The remedy for the Commission's failure to earlier in the 2001 review process reconcile the original benchmarks with its reporting requirements necessarily involved making adjustments either to the original benchmarks or the reported costs. The Commission chose the latter in implementing the Appeal Panel's decision because it had less information on how the original benchmarks were set, than on how the businesses had reported their costs;

- The Appeal Panel said that to obtain a measure of efficiency for the purposes of incorporation in the efficiency carryover mechanism, it is necessary that accounts which are being compared are produced on a comparable basis, and that these accounts cover a comparable range of operations (what the Commission now terms the need to "compare out-turn costs on a like-for-like basis with the appropriate benchmarks"<sup>20</sup>);
- Importantly, this principle relates to a "range of operations". Its source, and application, in the appeal was the inclusion in the regulatory accounts of some distributors, but not in others, of "expenditure incorporating certain retail functions" or "costs associated with retail operations"<sup>21</sup>;

The Appeal Panel's findings in no way support the conclusions that:

- the Commission has made adjustments...to clearly represent the costs of providing the services;<sup>22</sup>
- additional adjustments have been made to take into account...transfer pricing where these arrangements may...not accurately represent the costs incurred by a distributor in providing distribution services;<sup>23</sup>
- in comparing costs with benchmarks...it is not appropriate to consider additional fees or transfer prices that do not represent the cost of providing the distribution services<sup>24</sup>;
- If the Appeal Panel decision supports adjustments to regulatory accounts (which UED does not accept), it only supports adjustments to ensure the range of operations or functions for which costs are reported are "like-for-like" the range of operations or functions the subject of the benchmarks. It does not support adjustments that go behind the reported costs to seek out what the Commission regards as the cost of providing those operations;

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<sup>20</sup> ESC, Electricity Distribution Price Review 2006-10: Draft Decision, June 2005, page 155

<sup>21</sup> Appeal Panel for UED, Statement of Reasons, 30 October 2000, page 15

<sup>22</sup> ESC, Electricity Distribution Price Review 2006-10: Draft Decision, June 2005, page 159

<sup>23</sup> Ibid., page 159

<sup>24</sup> Ibid, page 164

## Relevant Costs (Related Party Transactions)

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- In relation to consistency between distributors, properly read, the Panel's concern was that "it should not be the case that that some distribution businesses are credited with efficiency improvements whilst others are not, solely because of their fortuitous choice of accounting base when submitting their 1999 regulatory accounts"<sup>25</sup>. The circumstances of the Appeal Panel's concern was that the lack of clarity from the Commission at the time of the preparation of the 1999 regulatory accounts had led at least one business to prepare accounts consistent with the KPMG format whilst others had not. The Appeal Panel required consistency between businesses to cater for the uncertainty created by the Commission and to remove the element of luck in these circumstances;
- It is thus of no assistance to the Commission to rely on the Appeal Panel's findings to make "adjustments to take into account transfer pricing where these arrangements may advantage or disadvantage a particular distributor"<sup>26</sup> and to make an adjustment where the value of a related party contract is greater than the costs of providing the services to "ensure that a distributor that does not enter into arrangements with related parties is not disadvantaged compared to a distributor that does."<sup>27</sup>; and
- The Appeal Panel decision does not support adjustments to the regulatory accounts to ensure that the cost outcomes for the distribution businesses from the way they choose to structure their affairs are consistent amongst them. The Appeal Panel decision relates solely and simply to consistency in the approach to the preparation of regulatory accounts.

Furthermore:

- The Appeal Panel's findings related to the *transitional* mechanism;
- The *transitional* mechanism was introduced by the regulator because it only decided how efficiency gains would be treated for the first price control period towards the end of that period;
- The whole point of the *long term* mechanism was to rectify these problems and thus remove the need for adjustments and the uncertainties that arose during the first period;
- It is thus inappropriate to rely upon the findings of the Appeal Panel in the context of the *transitional* mechanism to justify movement away from the representations made about the application of the *long term* mechanism.

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<sup>25</sup> Appeal Panel for UED, Statement of Reasons, 30 October 2000, paragraph 15

<sup>26</sup> ESC, Electricity Distribution Price Review 2006-10: Draft Decision, June 2005, page 159

<sup>27</sup> Ibid., page 164



## Relevant Costs (Related Party Transactions)

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The 2001 Appeal Panel Decision does not support the principle that adjustments to reported costs are, in the normal course of events, the appropriate way to implement incentive regulation.

The Commission's "need" for adjustments in the 2006 EDPR is therefore a direct result of the Commission's failure to develop a method of setting expenditure benchmarks that is:

"...transparent, easy to administer and replicable from one regulatory period to the next."<sup>28</sup>

The Commission should not if it is submitted opportunistically construct an argument around the Appeal Panel outcomes to support its policy position on related party costs. The Commission must properly establish its position by reference to its objectives and the positions it has to date adopted and laid down to date in this process.

This submission now addresses these objectives and positions.

### 4.2 Misinterpreting the Primary Objective and a Failure to Adopt the Best Available Regulatory Methodology

The Commission argues that the use of related party transactions and their apparent potential to enable businesses to retain efficiency gains longer than the Commission wants:

"...is clearly inconsistent with the Commission's obligations to protect the long term interests of customers with regard to price and service and ensure the benefits of efficiencies are shared with customers."<sup>29</sup>

This effectively endorses the Commission's adjustments to the reported costs.

In UED's submission, the Commission's Draft Decision reflects an erroneous and internally inconsistent interpretation of the Commission's statutory primary objective. It is erroneous because it assumes that setting expenditure benchmarks at the efficient level is the only approach consistent with meeting the long term interests of customers. It is internally inconsistent because elsewhere in the Draft Decision it assumes the long term to be 20 years, and yet it is seeking to set operating expenditures at their efficient level every five years.

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<sup>28</sup> ORG, 2001 EDPD: Volume 1 Statement of Purpose and Reasons, September 2000, page 87.

<sup>29</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, p 165. It is possible that the Commission is arguing that this outcome is only inconsistent with the primary objective if the efficiency gains are retained permanently, but its Draft Decision suggests otherwise. Moreover, if that were true UED would be in agreement with the Commission.

## Relevant Costs (Related Party Transactions)

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### 4.2.1 The Long Term Interests of Customers

The primary objective is about protecting the “long term” interests of customers. It is therefore important to understand what the “long term” might mean.

Unfortunately, the Commission has not been prepared to state explicitly what it believes the “long term” means, nor has it been prepared to state what it believes the primary objective means.<sup>30</sup> Instead, the Commission merely states in the Draft Decision that:

“...the Commission has exercised the broad discretion allowed to it under its legal framework, while also complying with the objectives and requirements of this framework.”<sup>31</sup>

Elsewhere in the Draft Decision, however, the Commission uses a reference point of 20 years to illustrate what it means by the long term. Under a description of incentives to protect reliability in the long term, the Commission states:

“The distributors were required to demonstrate that the service incentive arrangements proposed by them will provide appropriate incentives in both the short term, that is, within the regulatory period, and the long term, for example, a 20 year horizon.”<sup>32</sup>

A time frame of 20 years would appear to be consistent with the intention of policy makers, as Appendix C illustrates. It is also relevant when considering the regulator’s “long term” mechanism for setting operating expenditure benchmarks and rewarding efficiency gains, as Section 3.1 discusses.

### 4.2.2 Striving for the “Perfect” Efficient Cost (Expenditure) Without Regard to the Economic Cost

Whatever might be the Commission’s view on the meaning of “long term”, it appears to be of the view that its task in setting base operating and maintenance expenditure benchmarks is to provide the businesses with efficient costs at each price review. The Commission makes a number of references to this objective.

It is not obvious why the long term interests of customers are only (or are best) served by setting base operating and maintenance expenditure benchmarks at their efficient level every five years.

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<sup>30</sup> Moreover, the Commission does not address the primary objective in any detail in the Commission’s first Annual Report 2001-02 or in its Corporate Plan 2003/06. The 2003 Gas Access Arrangements Review was undertaken primarily under the National Gas Code.

<sup>31</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, p. 24. This appears to suggest that the primary objective was a secondary consideration in the Commission’s decision making process; secondary to exercising its discretion. It may be within the Commission’s discretion to adopt such a position to defining the long term, but it reveals the Commission’s views in practice on providing transparency and certainty in its decision making process.

<sup>32</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, p. 110.



## Relevant Costs (Related Party Transactions)

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It is self-evident that this would only be the case if the benefits of doing so exceed the costs.

The benefits of this approach for customers might be that allowed costs and thus prices are in the short term lower than they otherwise would be.

The costs of this approach for customers are that it might discourage businesses from pursuing efficiency gains in the first place, notwithstanding the efficiency carryover mechanism. In other words, in seeking to pass whatever gains that might be available in the short term to customers by resetting costs at their efficient level, the regulator might well be limiting the gains that business would otherwise generate over the longer term. In these circumstances, the Commission's approach to setting expenditure benchmarks will not be consistent with the long term interests of customers.

Moreover, the Commission's approach assumes it is feasible for it to determine efficient costs. The Commission's new approach appears to suggest it "knows" what the efficient costs are. This is evident from the number of relatively minor adjustments it is proposing to make to a number of the distributors' reported costs. It can only be making these adjustments on the basis of some view of what are the "right" costs.<sup>33</sup>

All the available evidence contradicts the view that regulators can know what the efficient costs are, which is why the Commission originally opted for the inferential approach. The economic costs associated with the Commission's approach are likely to be substantial.

The economic costs of the Commission's approach to setting operating and maintenance expenditure benchmarks is likely to be particularly important in light of the:

- Changes in the Commission's approach (because the businesses cannot be sure what approach it will adopt in future decisions); and
- Trends toward industry integration that the Commission observes but does not address.

Despite the obvious importance of the trade-off between the benefits and costs of attempting to set operating expenditure at the efficient level every five years, a recognition of this trade-off is entirely absent from the Commission's analysis. It just talks about benefits.

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<sup>33</sup> The only alternative is that it is looking at categories of costs in isolation and determining whether they are "efficient". However, this is not necessarily consistent with determining the efficiency of the overall level of costs either (ie. a business might have higher costs in one category and corresponding lower costs in another category, by virtue of efficient business decisions it has made).

## Relevant Costs (Related Party Transactions)

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### 4.2.3 Is this the Best Regulatory Methodology?

Section 33(2) of the *Essential Services Commission Act 2001* requires the Commission, in making a price determination, “to adopt an approach and methodology which the Commission considers will best meet the objectives specified in the Act and in the Electricity Industry Act 2000”.

UED submits the Commission must have particular regard to the fact that its primary objective directs the Commission to the long term interests of customers, not only with regard to price, but also with regard to quality and reliability. UED notes the Commission has endorsed this objective as a matter of regulatory principle in the context of the Productivity Commission Review of the Gas Access Regime, which as a regime for price regulation is analogous for these purposes, in saying:

“The ESC agrees with the Draft Report that the overall objective of the Gas Access Regime must be to foster long-run economic efficiency....”<sup>34</sup>

The Commission is required to adopt an approach and methodology that best meets this objective. It is UED’s submission that the Commission must, as a matter of law, have regard to the outcomes of recent independent reviews of regulation and regulatory decisions to determine the best approach and methodology that protects the long term interests of customers.

These recent developments have provided greater clarity on how the objectives of regulation should be interpreted, and thus how regulation should be applied. In particular, there are important lessons relating to the question of how regulators should best discharge their statutory duties.

In the Epic Decision<sup>35</sup> the Supreme Court of Western Australia determined that section 8(1)(b) of the National Gas Code should be interpreted as requiring the regulator to replicate the outcomes of a workably competitive market and made a number of comments about the task of regulators in replicating the outcomes of “workable competition”.

UED submits that the case establishes outcomes for which a regulator should strive when required to “replicate the outcome of a competitive market” and notes that clause 6.1.1(b)(3) of the National Electricity Code records that the key principles of that chapter include an intention “to regulate the non-competitive market for network services in a way which seeks the same outcomes as those achieved in competitive markets”. UED submits the Commission has committed to have regard to this principle as one which is consistent with the Victorian legal framework. In any event, UED believes the Epic Decision establishes the outcomes for which a regulator should strive when meeting an objective relating to the long term interests of customers.

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<sup>34</sup> Essential Services Commission, Submission to the Draft Report of the Productivity Commission Review of the Gas Access Regime, 7 April 2004, page 4

<sup>35</sup> *Re Dr Ken Michael AM; Ex parte Epic Energy (WA) Nominees Pty Ltd* [2002] WASCA 231.

## Relevant Costs (Related Party Transactions)

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One benefit from the Court's decision lies in the emphasis that the Court places on certain observable outcomes of a competitive market. These include that efficiency does not necessarily attain theoretically ideal or static efficiency.

The Australian Competition and Consumer Commission have discussed this issues<sup>36</sup> concluding that:

"[The] primary force of the Court's argument is that the regulator should not place undue weight on static concepts of efficiency. Instead, according to the Court, the regulator should place due weight on the dynamic efficiency outcomes of competitive markets –the incentives to take risks, to exploit opportunities and to innovate. This could lead to temporary (or even prolonged) deviations from some narrow notions of efficiency, but to the greater good of efficiency overall."<sup>37</sup>

The ACCC went on:

"Finally, the Court seems to acknowledge that a workably competitive market must be sustainable in the long run: 'The expert evidence ... suggested a growing awareness of the long term disadvantages of striking the balance [between the interests of consumers in obtaining low prices and the service provider in receiving high prices] with too great an emphasis on the interest of consumers in securing lower prices, and without due regard to the interest of the service provider in recovering both higher prices and its investment."<sup>38</sup>

Productivity Commission reviews, other independent reviews<sup>39</sup>; the Epic Decision; and appeal decisions by the Australian Competition Tribunal<sup>40</sup> represent a significant body of authoritative and independent opinion that demonstrates the importance of avoiding regulatory error, and the risks to regulated infrastructure investment - and thus the long term interests of customers - that arise from those errors.

There is a strong case for regulators' decisions to err in favour of encouraging more, rather than less infrastructure investment. The goal is not a solution represented by absolute or precise qualities but to foster long term customer benefits through investment and dynamic efficiency.

The Commission has had no regard to these matters.

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<sup>36</sup> ACCC, Submission to the Productivity Commission Review of the Gas Access Regime, 15 September 2003, attachment 1

<sup>37</sup> *ibid*, page 112.

<sup>38</sup> *ibid*, page 113.

<sup>39</sup> Council of Australia Governments Energy Market Review Panel, Towards a Truly National and Efficient Energy Market: Final Report [Parer Report], 20 December 2002.

<sup>40</sup> See for example, Application by GasNet Australia (Operations) Pty Ltd [2003] ACompT 6; Application by East Australian Pipeline Limited [2004] ACompT 8; and Application by Epic Energy South Australia Pty Ltd [2003] ACompT 5.

## Relevant Costs (Related Party Transactions)

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### 4.3 Failure to have Regard to the Economic Costs of Regulatory Uncertainty

As indicated above, in forming the view that it is in the long term interests of customers to re-establish the efficient operating and maintenance costs every five years, the Commission fails to have regard to the costs to economic efficiency.

One particular economic cost it fails to consider is the cost of regulatory uncertainty. The Commission appears to be of the view that it can change its approach to setting relevant costs at any time, and that there are no economic costs associated with changing its approach.

The evidence comes from the changes in the regulator's approach to:

- Establishing base operating and maintenance expenditure benchmarks;
- Rewarding efficiency gains; and
- The treatment of particular related party contracts and, in particular, the defining of market testing.

Section 3 discusses these issues.

In proposing to change its approach, the Commission again highlights the apparent benefits of doing so. However, there is no assessment of the economic costs that might be associated with changing its approach, or changing its approach in the short term during a price review process. In other words, even if the Commission proposed changes in approach were appropriate (which UED does not accept), then it is open to question whether it is appropriate to introduce the changes with no prior warning.

The Commission may argue that it is using a “combination” of reported costs and benchmarking to set base operating expenditure benchmarks. But this only exacerbates the problem. Using reported costs or benchmarking to set future expenditure benchmarks are, or at least should be, mutually exclusive approaches to regulation. This is because any advantages of the former approach can only be realised if the business knows that the regulator will stick to the rules. If, however, the Commission is going to rely on reported costs except where it finds costs it does not like, then this can only undermine the businesses' confidence in the approach. If their confidence is undermined, so will be the incentives for efficiency.

The economic costs of the Commission's proposed approach are likely to be reduced certainty on the future setting of operating expenditure benchmarks and the future treatment of efficiency gains, and felt through a lack of innovation and investment. The costs are also likely to include a higher cost of capital both debt and equity, as credit rating agencies and investors become more wary of the lack of certainty and predictability in the regulatory regime. These costs will be borne by customers over the longer term.

The Commission Draft Decision fails to have regard to these economic costs.

## Relevant Costs (Related Party Transactions)

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### 4.4 The Commission's Failure to take UED's Submissions into Account

The Commission states in respect of related parties and market testing that:

"You can be assured that the Commission has taken into account all of the submissions and information that UED (and Alinta) has provided to it to date, although it was constrained in the detail in which it could actually respond to some of those submissions in its Draft Determination given that UED provided much of the relevant information to the Commission in confidence."<sup>41</sup>

This statement gives the impression that the Commission has engaged in a proper process on the related party issue when, for the reasons set out in section 2 and elsewhere herein, the Commission's processes for assessing related party costs are flawed.

It is not sufficient for the Commission to provide "assurance" that it has taken submissions into account. Rather, the Commission is obliged to make a decision and provide reasons that demonstrate it has taken submissions into account. The Commission does not appear either to accept this or appreciate the distinction.

The confidentiality issue is at best misleading because:

- The Commission's Draft Decision makes no attempt to justify its position on market testing nor does it make reference to UED's two confidential submissions;
- The Commission's Draft Decision makes no reference to the problem it has subsequently identified in addressing the arguments contained in UED's submissions;
- Confidentiality would not preclude the Commission from communicating directly with UED either in writing or verbally on its submissions (as it has committed but failed to do);
- Confidentiality would presumably not preclude the Commission from addressing the key "in principle" issues raised by UED, without referring to the detail in UED's submissions; and
- Even if confidentiality might create the constraint the Commission suggests, it would not preclude the Commission from asking UED whether it could refer to these submissions in formulating its Draft Decision. Alternatively, it could have asked to have certain sections removed from the confidentiality constraint, so it could address the issues.

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<sup>41</sup> Letter from AC Larkin, Acting Chairperson, Essential Services Commission, Provision of Information, 20 July 2005, page 1.



## Relevant Costs (Related Party Transactions)

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### 5 Other Factual Flaws

There are other narrower flaws in the Commission's analysis, which include those outlined below.

#### 5.1 UED's Costs

The Commission has asserted that at least some of UED's costs are not reflective of the cost of providing the service. The Commission concludes that:

"United Energy claims that the competitive tension between DUET (asset owner and majority shareholder) and Alinta (asset operator and minority shareholder) ensures that the contract price for services provided to United Energy by an Alinta subsidiary is efficient because the asset owner has no incentive to pay more than it should for services because this puts its return at risk. However, the information provided to the Commission in confidential submissions indicates that the value of the contract does not reflect the costs of providing distribution services. No adjustment has been made at this time however, as the Commission is seeking further information on the costs incurred in providing distribution services."

UED does not know how the Commission has formed this view and considers that the view adopted is unsustainable. As far as UED is aware, it has provided no confidential information, which would allow the Commission to draw the conclusion that the value of the contract does not reflect the cost of providing distribution services.

#### 5.2 UED's Views

The Commission attributes some views to UED that are, as far as it is aware, not views it has expressed. In discussing why it believes that competitive, arm's length tender processes are the only acceptable form of market testing, the Commission states that:

"However, the Commission strongly disagrees with the proposition advanced by United Energy that, where an arms-length tender process has not been conducted and where the cost of providing the service is less than the value of the related party contract, adjusting to reflect the actual cost of service provision would be contrary to the requirements of the regulatory regime."

As far as UED is aware, at no time has it advanced such a proposition either in public or confidential submissions.

UED's position is simply that where market testing has occurred, it is reasonable to infer that the costs are efficient (as it has always maintained and the Commission previously accepted). It is also reasonable to infer that efficiency gains will pass to customers just as they would if the asset owner and the service provider were "unrelated".



## Relevant Costs (Related Party Transactions)

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### Appendix A - The relationship between the parties

#### The Parties

There are four key parties relevant to understanding the operation of UED, in addition to UED:

- The Diversified Utilities and Energy Trust (“DUET”). DUET is a listed entity based in Sydney, managed jointly by AMP Capital Investors and Macquarie Bank;
- Alinta Ltd (“Alinta”) is a listed entity based in Perth. It is a leading provider of energy-related products and infrastructure solutions;
- Alinta Network Services Pty Ltd (“ANS”) is based in Moorabbin, Melbourne. It provides asset management services in the energy sector; and
- United Energy Distribution Holdings Pty Ltd (“UEDH”) is based in Mt Waverley, Melbourne. It represents the asset owners’ interests and provides corporate services to UED.

#### The Ownership Structure

- DUET owns 66% of UEDH;
- Alinta owns 34% of UEDH;
- ANS as a wholly owned subsidiary of Alinta; and
- UEDH owns UED.

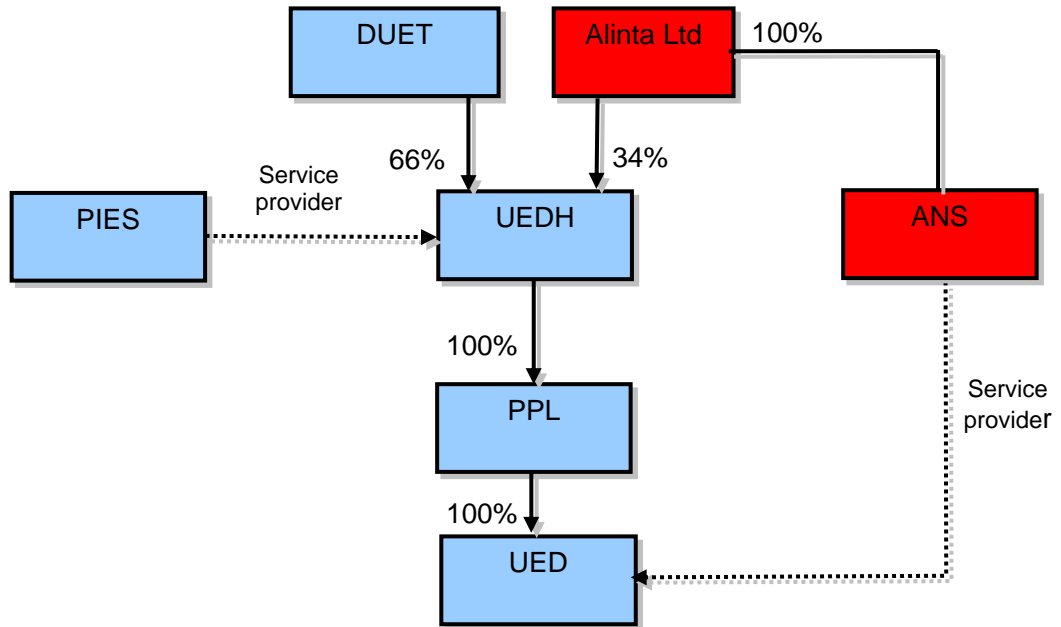
#### The Commercial Arrangements

- UED acquires most of its operating and maintenance services and capital expenditure service requirements from ANS. The contract was established through commercial bi-lateral negotiation;
- UED acquires corporate services from UEDH. UEDH charges UED based upon benchmarks established for a range of similar services. UEDH in turn acquires some of these services from Pacific Indian Energy Services (“PIES”) and its ultimate shareholders; and
- UED entered into these service agreements in July 2003, as part of the transaction whereby Aquila (a US utility) exited the Australian market and which resulted in the current ownership structure.

The diagram below summarises the commercial structure within which UED operates.

## Relevant Costs (Related Party Transactions)

**Diagram 1 – The Commercial Structure within which UED Operates**



Note: PIES is majority owned and controlled by DUET by virtue of DUET's ownership in UEDH

### Appendix B - The Commission's Approach to Market Testing

This appendix summarises the background to the Commission's interest in the 2006 EDP on related party transactions and market testing in particular.

- In the 2001 EDP the regulator did not raise the issue of related party contracts or market testing at all, despite the presence of related party transactions. It did make an adjustment to indirect overheads for management fees that it argued represented a transfer of profit to a parent company.

During the intervening period, as far as UED is aware, the regulator made no comments about how the industry was evolving in respect of integration and emerging methods of service delivery (ie. the separation of asset ownership and operation). It produced no policy or position papers on this issue, unlike Ofgem for example, which the Commission uses as a precedent in its Draft Decision to support its definition of market testing.

- On 30 January 2004 the Commission issued revised regulatory accounting guidelines.<sup>42</sup> In respect of related party transactions, it introduced (at section 5.24.1) the following requirement for market testing:

“...a description of how the transaction was arrived at, including any market testing undertaken”.

Market testing was not a defined term in the guidelines, nor was it defined or discussed in any of the Commission's consultation papers in respect of the revision of the regulatory accounting guidelines. The guidelines also only refer to “any” market testing, which suggests that the requirement for market testing is not mandatory.

During the intervening period the Commission continued to receive UED's regulatory accounts, make no comment on them in respect of related party transactions, and used them for the purpose of its published comparative performance reporting.

- On 23 February 2004 the Commission released an open letter announcing the commencement of the 2006 Electricity Distribution Price Review.
- Between 9 March 2004 and 17 May 2004 the Commission released three consultation papers. This process culminated in the Commission producing its Final Framework and Approach Guidance Paper on 30 June 2004. This called for the electricity distributors to submit price-service proposals for the 2006-10 regulatory period. The Commission stated that:

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<sup>42</sup> ESC, Electricity Industry Guideline No.3: Regulatory Information Requirements, January 2004.

## Relevant Costs (Related Party Transactions)

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“The purpose of this paper is to set out for stakeholders the framework and approach that the Commission will use to make a final decision on the price controls that should apply to distribution use of system charges from 1 January 2006. It also provides guidance to the licensed electricity distribution businesses for the preparation of their submissions on their revenue, tariff and service proposals for the five years from 2006.”<sup>43</sup>

None of these papers either mentions related party transactions, market testing or any issues with the regulatory accounting statements. Moreover, when outlining how it would set expenditure benchmarks for the 2006 period, the Commission stated in its Final Framework and Approach as follows:

“As foreshadowed in the 2001-05 price review, the Commission considers that it can rely on the incentive properties of the CPI-X framework, incorporating the efficiency carryover mechanism, to provide incentives for distributors to achieve efficiencies in opex. The aim of including an efficiency carryover mechanism in the 2001-05 price review was to provide distributors with a stronger incentive to achieve efficiencies. A corollary of this is that distributors would be expected to reveal their efficient level of costs, because they are directly rewarded for outperforming the expenditure forecasts established at the last price review. Hence, the Commission can infer that reported actual costs are efficient. Where the scope of activities is unchanged, this inferential approach reduces the need for reliance on external benchmarking processes to assess the efficiency of cost forecasts put forward by the distributors.”<sup>44</sup>

- On 15 July 2004 the Commission commenced a review of the electricity distributors’ regulatory accounts for 2000-03 amongst other things to “*provide assurance to the Commission that the regulatory accounts reveal the efficient costs of the distributors.*” In respect of related party transactions, it requested as follows:

“Please provide any further evidence you may have to indicate that the related party contracts have been market tested. In the absence of such information, the Commission will require United Energy to demonstrate that these contracts reflect efficient costs.”<sup>45</sup>

This led to a series of letters and emails between the Commission and UED in respect of numerous issues associated with the regulatory accounts, including related party transactions and market testing. This includes letters from the

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<sup>43</sup> ESC, EDPR 2006-10, Final Framework and Approach: Volume 1, Guidance Paper, June 2004, Preface.

<sup>44</sup> ESC, EDPR 2006-10, Final Framework and Approach: Volume 1, Guidance Paper, June 2004, page 66.

<sup>45</sup> ESC, Regulatory Accounts: Letter from Marianne Lourey, Manager – Network Regulation, 15 July 2005.

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Commission dated 3 September 2004<sup>46</sup>, 17 September 2004<sup>47</sup>, 22 December 2004<sup>48</sup> and 6 January 2005.<sup>49</sup>

At no stage of this process did the Commission attach any particular meaning to the term “market testing”.

- On 21 October 2004 the distributors submitted their price-service proposals.
- On 15 November 2004 the Commission produced a paper summarising the distributors’ price service proposals. This paper did not mention either related party transactions, market testing or any problems with the regulatory accounting statements.
- On 14 December 2004 the ESC published an Issues Paper. This was the first paper to raise the issue of related party transactions. It referred to the review of the regulatory accounts and expressed concerns about the capacity of related party transactions to allow distributors to retain efficiency gains. It sought comment on whether this was appropriate.

The paper made no mention of the possibility that related party transactions might be in customers’ interests. It also made no mention of the requirement for market testing or what it meant.

- One 28 January 2005 responded to the Issues Paper arguing that “related parties must be capable of earning profits if out-sourcing is to deliver efficiency gains to shareholders and customers alike. UED believes that the Commission’s concerns are ill-founded, and the company stands ready to discuss these matters further with the Commission.”
- On the 15 March 2005 UED met with the Commission (at UED’s request) to discuss some issues associated with regulatory accounting information, including related parties. In relation to the latter, the Commission argued that provided there was evidence of market testing, it could infer that the reported costs were efficient and it would not require detailed cost information. It also argued that open competitive tenders were what it means by market testing, although it conceded that this would not always be feasible.

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<sup>46</sup> ESC, Regulatory Accounts: Letter from Marianne Lourey, Manager – Network Regulation, 3 September 2004

<sup>47</sup> ESC, Regulatory Accounts: Letter from Marianne Lourey, Manager – Network Regulation, 17 September 2004

<sup>48</sup> ESC, Regulatory Accounts: Letter from Marianne Lourey, Manager – Network Regulation, 22 December 2004

<sup>49</sup> ESC, Arrangements between United Energy Distribution Pty Ltd and Alinta Network Services Pty Ltd: Letter from Paul Fearon, Chief Executive, 6 January 2005.

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- On 24 March 2005 the Commission issued its Position Paper. It reiterated the Commission's concerns in respect of related party transactions. In respect of market testing, it stated:

"...the only objective way to ensure that a related party contract is efficient is through objective market-testing of the contract – that is, through a competitive tendering process."<sup>50</sup>

It relied on a draft guideline by Ofwat as evidence of what market testing should mean.

This was the first time that the Commission mentioned market testing in the price review process in written form. It is also the first time the Commission offered an opinion in written form on what market testing meant. The Commission did not consult with the distributors on the meaning of market testing.

In respect of the process, the Commission stated that:

"The Commission is awaiting further information from Powercor and United Energy. United Energy believes that it will be able to demonstrate that its related party contracts have been market-tested."<sup>51</sup>

It also stated that:

"The Commission's review of the distributors' regulatory accounting statements has identified the need to revise the Commission's Regulatory Accounting Guideline. In conjunction with this review, the Commission proposes to provide clearer guidance in relation to related party contracts. This will include a clearer definition of what constitutes market-testing and the policies and procedures required to be implemented by the distributor to demonstrate that appropriate market-testing has been undertaken within a competitive environment. Where appropriate market-testing has not been undertaken within a competitive market, the distributor will continue to be required to report actual costs incurred by the related party."<sup>52</sup>

The Commission would appear to concede that regulatory accounting guidelines were unclear in respect of what was required in regard to reporting related party contracts and what market testing means. However, this has not stopped it from retrospectively defining what it means.

- On 8 April 2005 UED submitted a detailed confidential report in relation to its service acquisition. This report highlighted:
  - The differences in UED's commercial structure compared to those entered into by some of the distributors (most notably AGL, CitiPower and Powercor);

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<sup>50</sup> ESC, EDPR 2006-10: Position Paper, March 2005, page 28.

<sup>51</sup> Ibid, page 29.

<sup>52</sup> Ibid page 29.

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- How UED’s service acquisition has been market tested; and
- The limitations in the Commission’s position (eg. its definition is retrospective, incorrect and not supported by ordinary principles of statutory interpretation).
- On 12 April 2005 UED met with the Commission to discuss a number of regulatory accounting matters. The Commission had not had time to review UED’s paper on service acquisition, so it was not discussed at the meeting. However, the Commission argued that in addition to evidence of market testing, it would also require evidence that efficiency gains pass to customers.
- On 21 April 2005 UED submitted its response to the Commission’s position paper. It essentially reiterated the arguments put forward in UED’s report on service acquisition and pointed out the contradictions in the Commission’s new views on external benchmarking. It is also stated that: “UED will continue to discuss this important matter with the Commission in order to seek a resolution.”
- On 6 May 2005 UED submitted a detailed confidential report in relation to the passing through of efficiency gains (in response to the meeting with the Commission). The key points this paper made was that:
  - UED did not believe that its service acquisition worked any differently to the way it would work if it were with “unrelated” parties; and
  - The key issue was not therefore how the arrangements pass efficiency gains to customers; rather it was whether they have been adequately market tested.
- On 24 May 2005 the Commission issued an informal information request in relation to related party transactions to all the distributors.
- On 3 June 2005 UED wrote to the Commission questioning why it had issued the information request to UED when it had not responded to any of UED’s submissions despite assurances that it would do so. UED stated:

As your officers will be aware, we have:

- Already provided the Commission with two detailed reports which provide considerable information directly relevant to your request (one on market testing and the other on passing efficiency gains to customers); and
- Received no response to either report despite your officers’ commitment to provide feedback and our further enquiries on whether the Commission required any additional information.

These circumstances create the impression either that the Commission:

- Has failed to have regard to the information we provided, as is reflected in the Commission determining that UED should be subject to an information request that we understand has been made to all distributors; or

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- Does not accept the information and arguments we have put forward, but without explaining why - thus denying UED the opportunity to address your outstanding concerns.

We question why Commission is requesting further information from UED when it has not outlined its views on whether, on the tests it has set out (eg. on market testing), the information already provided is insufficient.

It also requested that the Commission inform UED:

When, and in what form, the Commission proposes to respond to the papers we have already submitted and whether it is the Commission's intention to discuss those papers with us.

UED has received no response to its request despite repeated attempts to encourage the Commission to respond to it.

- On the 10 June 2005 UED responded to the informal information request. That response:
  - Provided the material that could be provided in the time available;
  - Pointed out that some material over which there were commercial confidentiality issues would require the consent of the counterparty (Alinta);
  - Stated that we had informed Alinta of your request. It indicated that it would make a submission direct to the Commission outlining why it was reluctant to release its agreement with Alinta Network Services; and
  - Outlined UED's concerns with the process the Commission has adopted in regard to related party transactions, as per our letter of 10 June 2005.

It also pointed out that the Commission had still not responded to any of its requests for consultation on these issues.

- On 22 June 2005 the Commission issued its Draft Decision. In it the Commission states:

“The Commission acknowledges that evidence of effective market testing of the value of related party contracts would be a relevant consideration in deciding whether to seek actual costs or to accept the contract price. However, the only evidence the Commission considers acceptable for this purpose would be evidence that the related party won the service contract in a competitive, arms-length tender process”.<sup>53</sup>

It provides no explanation of how it came to this view, why its view has shifted or why it relies (albeit incorrectly) on Ofgem and Australian Taxation Office precedents, or why it has changed the precedents it relies on relative to the Position Paper (ie. Ofwat).

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<sup>53</sup> ESC, EDPR 2006-10: Draft Decision, June 2005, page 164.



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It also provides no explanation for why it quotes (albeit selectively) from UED's response to the Position Paper, but makes no mention of the two detailed confidential submissions UED made on this issue.

- On 27 June 2005 Alinta submitted a detailed confidential report to the Commission outlining why it was reluctant to release the agreement between Alinta Network Services and UED.

As far as we are aware, the Commission has not responded to Alinta's submission.

- On 29 June 2005 the Commission issued a further information request which:
  - Requested additional information specifically in regard to the related party transactions between UED and National Power Services 2001-03; and
  - Reiterating the Commission's position in respect of wanting to see the agreement between UED and Alinta Network Services.
- On 8 July 2005 UED responded to the informal information request.
- On 20 July 2005 the Commission issued a further information request. This appears to abandon the market testing concept as a relevant indicator of whether the Commission could infer that the reported costs are efficient, and thus whether it should seek actual costs. This contradicts the Commission's position in the Draft Decision. It also appeared to distance itself from any definition of market testing.

### Appendix C - Interpreting the Primary Objective

Section 8(1) of the Essential Services Commission Act 2001 states:

“The primary objective of the Commission is to protect the long-term interests of Victorian consumers with regard to the price, quality and reliability of essential services.”<sup>54</sup>

The primary objective is unsurprisingly about ensuring that the key features of the “product” that are of interest to customers (ie. price and service, and the trade-off between them) are the focus of the regulatory regime. However, the primary objective explicitly focuses on protecting the *long term* interests of customers in relation to these key features.

Two key inferences can be drawn from the primary objective:

- First, in the absence of “protection”, the consumers’ interests in relation to the price, reliability and quality of electricity distribution services might not be served; and
- Second, “protecting” consumers’ interests in the short to medium term is not necessarily consistent with protecting their interests in the long term. This implies that there are trade-offs between and within price and service. In other words, there may be determinations that the Commission could make that are in customers’ short term interests (eg. lower prices), but which are not in their long term interests (eg. because efficiency and investment are discouraged). Another possible implication is that the primary objective goes beyond merely ensuring that the industry remains viable.<sup>55</sup>

The first inference provides the rationale for some form of regulation, while the second inference goes to what that regulation should be trying to achieve over time, and thus its appropriate application. The key outstanding question is: what the “long term” means?

Perhaps the best indication of what the “long term” means in this context comes from the parliamentary debate that occurred during the development of the Essential Services Commission Act 2001. It is worth noting that the original exposure draft did not refer to the “long term” interest of consumers; this was only inserted after further consultation, as is highlighted in the relevant parliamentary debate below:<sup>56</sup>

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<sup>54</sup> ESC, EDPR 2006-10, Consultation Paper No. 1: Framework and Approach, March 2004, page 5.

<sup>55</sup> This is particularly the case given the risks and uncertainties associated with ensuring revenues are “just sufficient”. A business regulated like this is only likely to engage in “stay in business” investment.

<sup>56</sup> Parliament of Victoria – Hansard<<http://www.parliament.vic.gov.au>> Legislative Council, Essential Services Commission Bill, 17 October 2001, pages 827-30.

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Hon. C.C. Broad (Minister for Energy and Resources) - "I shall add briefly to what I have already said and indicate that this change was made as a result of consultation not just with industry but also with representatives of consumers, who also see this as being a very important change in the interests of current and future consumers."

Hon. D. McL. Davis (East Yarra) - "As do other honourable members, I welcome the move from the exposure draft on the insertion of the words 'long term interests'. I seek further clarification as to what those words mean. I know that the briefing, and I thank the minister for it, was helpful to the opposition and produced the phrase 'beyond the five-year pricing period'; but what does the government understand by the expression 'long term'? A number of definitions could be given. 'Long term' could relate to electoral cycles or an economic view of this clause, or it could apply to some other phrase that was given to us – for example, 'beyond the five-year pricing period'.

My concern about that description is that in these utility areas 'long term' is in my view a great deal longer than any of those cycles – it is cycles of 10, 20 or 30 years. Is that what the minister means by 'long term'? Can she point to other legislation for an interpretation that would give us a better explanation?"

Hon. C.C. Broad (Minister for Energy and Resources) – I can set the honourable member's mind at rest and indicate that it is certainly not the view of the government, consumer representatives or the industry that electoral cycles are in any shape or form an appropriate time period. However, the appropriate time period would vary depending on the nature of the infrastructure and the essential service.

As the honourable member said, in the briefing it was indicated as being beyond the five-year pricing reviews undertaken by the current Office of the Regulator-General. However, in terms of being precise about what might be the appropriate definition of 'long term' for a particular essential service, it would be a matter which would have to have regard for the nature of the investment and the interests of consumers in relation to that investment in infrastructure".

Hon. D. McL. Davis (East Yarra) – Do I understand the minister to be saying that it would be part driven by the investment with that understanding of the words 'long term'?

Hon. C. C. Broad (Minister for Energy and Resources) – Yes

During the debate the Minister for Energy and Resources also stated: "I am pleased that at least the shadow minister drew attention to the emphasis on long-term interests with regard to the primary objective, since in emphasising in the primary objective that reference to long-term interests the intent is that the interests of all current and future consumers are best served through regulatory arrangements that promote an environment for investment in essential utility services infrastructure for the long term."

It is worth noting that the development of the primary objective occurred at the same time as broader regulatory developments were highlighting the need to adopt a similar perspective (eg. the Productivity Commission's review of the National Access Regime).



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It would appear that in the Victorian Government's view the phrase "long term" in the primary objective relates to a period considerably longer than the price review period. The investment life cycle of the infrastructure in question would appear to be a key variable on which the "long term" is defined. In the case of electricity distribution infrastructure, this is likely to mean at least 20 years (eg. the average remaining life of UED's assets is about 50 years). This would be consistent with the economic meaning of the phrase "long term" which usually refers to the period over which a market can return to equilibrium (ie. with the replacement of the capital stock).