

Submission to Essential Services Commission:

Re: Gas Access Arrangement Review 2008 to 2012 Final Decision Response Summary



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List of Appendices

Company	Title of Report	Status
Operating & Maintenance Appendices		
Horton 4 Consulting	Opex Rate of Change and Productivity: Pacific Economic Group's Response to Consultant Reports	Public
Meyrick and Associates	Summary of Responses to PEG February 2008 Report on Opex Rate of Change – Forecast Opex Partial Productivity	Public
Multinet	OSA and Base Cost Calculation	Commercial in Confidence
Cost of Capital Appendices		
CEG	Memorandum on Beta	Public
NERA Economic Consulting	Preliminary Response to the ESC Final Decision	Public
SFG	Note on equity beta	Public
SFG	Note on GAMMA	Public

1 Introduction

On Friday, 7 March 2008, the Commission released its Final Decision for the 2008–2012 Gas Access Arrangement Review. The Commission did not accept Multinet’s proposed revised Access Arrangement and required a number of amendments in order to provide approval.

This submission is Multinet’s response to the Commission’s Final Decision. It consists of:

- a. Reasons for accepting or rejecting the Commission’s required amendments (this submission);
- b. Further expert evidence attached as appendices;
- c. Clean and tracked changed versions of Parts A, B and C of the revised Access Arrangements under section 2.40 of the Code; and
- d. An excel model with the final calculations.

Multinet makes this submission inviting the Commission to make a decision under section 2.41(b) of the Code. As a general comment, Multinet has accepted a majority of the Commission’s required amendments and has made the required changes. After careful consideration, Multinet has decided to not accept some of the Commission’s required amendments. The most significant one is the change to the P(0). By these revisions and this submission in support, Multinet has addressed the reasons for that amendment given by the Commission in its Final Decision. In addition to these submissions Multinet reiterates, in particular, the submissions it made in October and November in response to the Draft Decision. Overall these submissions provided sound reasons and expert evidence supporting Multinet’s position in response to the Draft Decision and this response to the Final Decision.

The detailed reasons are contained in this submission and can be summarised as:

- a. Cost of capital

The Commission’s decision does not accord with the nature of the Commission’s discretion or with the requirements of the Code based on the material supporting Multinet’s position. In particular, material relating to the equity beta, debt margin and inflation.

- b. Cost of tax

Again, the Commission’s decision does not accord with the nature of the Commission’s discretion or with the requirements of the Code A gamma of 0.35 complies with the Code, as established by the appeal panel in South Australia and the material presented in the October submission, and the Commission has not established it does not.

- c. Operating Expenditure

Multinet does not accept the Commission’s overall operating expenditure, being concerned about the inconsistencies and errors that have arisen in the Commission’s complex methodology which has disaggregated the expenditure forecasting process into multiple



independent steps. That said, Multinet has not sought to completely rewrite the methodology, but rather sought to correct the errors and inconsistencies that have arisen within the methodology. The key aspects of those corrections are set out in d and e below

d. 2006 operating cost base

The Commission has made an oversight by assuming that all Multinet's costs are incurred through the OSA and EPG fees. This assumption excludes the direct costs (including licence fees) that Multinet incurs.

e. Rate of change – partial factor productivity

Multinet maintains its view that the partial factor productivity (PFP) element of the rate of change calculation is subject to considerable estimation uncertainty and error. Consistent with the Code, Multinet's approach in its response to the Draft Decision was to steer a middle course between the different views expressed by 3 independent experts (including the Commission's expert). The Commission is wrong to prefer its own expert's conclusions and to ignore the criticisms made by the two other independent experts.

On 14 December 2007, Multinet first requested that the Commission provide it with any new material/evidence, make the experts available for interview and give Multinet an opportunity to make submissions before the Commission made its final decision. Multinet concluded correspondence on this issue in its letter of 22 February 2008 noting that if the Commission had new material that was adverse to Multinet and which informed the Commission's final decision, it would be wrong of the Commission not to have made it available to Multinet for comment.

Contrary to the process set out in section 2 of the Gas Code, and despite Multinet's representations on the issue of the use of new material, at the same time as the Commission published its final decision it also published for the first time a number of reports of the Allen Consulting Group and Pacific Economics Group.

As noted above, Multinet responds to this material today as it addresses the matters the Commission has identified in its final decision as being the reasons for requiring the amendments specified in that decision. Nevertheless, the Commission's approach has resulted in real prejudice to Multinet given the company has had 12 working days to consider the new material and prepare a response in the context of a process that has taken the best part of two years.

Multinet considers the Commission's understanding of the issues will be enhanced if Multinet has the opportunity to interview the authors of those reports, just as improving the Commission's understanding of Multinet's statements and expert reports formed the basis of earlier interviews conducted by the Commission. Moreover, Multinet considers that the prejudice to it arising from the Commission's approach can be addressed through interview and submission. Accordingly, Multinet requests that the Commission give it the opportunity to interview the authors of the Allen Consulting Group and Pacific Economics Group reports published by the Commission with its final decision and make further submissions before it makes its further final decision.



The Commission's approach does not promote transparent regulatory decision making and has resulted in disadvantage to Multinet. Accordingly, we look forward to a favorable response to our request.

2 Required Changes

The Commission has proposed that Multinet makes a number of amendments to its Access Arrangement in order for the Commission to provide final approval. Section 2 of the Commission's Final Decision details the required amendments.

Multinet itemises each of these required amendments below together with Multinet's response. In addition Multinet has provided a tracked changed version of the company's Access Arrangement as part of the overall response to the Commission's Final Decision.

2.1 Part A—Principal Arrangements-Ancillary Reference Services

2.1.1 Clause C—Turn on and Reconnection

Multinet is required to delete the words and replace them with
'and the performance of a safety check and the lighting of appliances where necessary'.

Multinet agrees to change and will make the necessary amendments.

2.1.2 Clause C—Turn on and Reconnection

Multinet is required to (1) include after hours connection and reconnection for tariff V customers in the schedule to its terms and conditions titled 'Services other than Reference Services' and (2) delete the sentence 'In addition to the hours specified

below, this service will be provided between the hours of 4.00pm and 8.00pm as a non-reference service' from its proposed turn on and reconnection Ancillary Reference Services.

Multinet agrees to change and will make the necessary amendments.

2.1.3 Extensions/Expansion Policy

Multinet is required to replace the term 'section 3.5' with the term 'Appendix 2' in its new clause 5.3.3(4A).

Multinet agrees to make this change; however, it assumes that the change relates to new clause 5.5.3 rather than 5.3.3.

2.2 Part B—Reference Tariff and Reference Tariff Policy

2.2.1 *P(0) Various—P(0) and X factors*

The Commission requires the distributors to adopt the following P0 and X factors in their respective Reference Tariff Policies

Multinet does not agree with the Commission's proposed change to the P(0). The detailed reasons are provided in Section 3 of this response.

2.2.2 *P(0) Various—Tariffs until 1 July 2008*

Part year tariffs The distributors are required to amend their Reference Tariff Policies to make clear that:

- the Reference Tariffs which applied in 2007 will continue to apply in nominal terms until 1 July 2008

Multinet agrees to change and will make the necessary amendments.

2.2.3 *P(0) Various—Tariffs from 1 July 2008*

Part year tariffs The distributors are required to amend their Reference Tariff Policies to make clear that:

- 2008 tariffs will only apply for the period 1 July 2008 to 31 December 2008

Multinet agrees to change and will make the necessary amendments.

2.2.4 *P(0) Various—Timeframes*

Part year tariffs The distributors are required to amend their Reference Tariff Policies to make clear that:

- the process set out in section 4 of each distributors' Reference Tariff Policy will be followed to determine tariffs for the period 1 July to 31 December 2008, however the time frames are amended to reflect the fact that new tariffs will commence on 1 July rather than at the start of the Calendar Year.

Multinet agrees to this change and will make the necessary amendments.

2.2.5 *Schedule 2—Ancillary Reference Service Prices*

Multinet is required to change the 2008 tariff for special meter reads in Schedule 2 of its Reference Tariff Policy to \$9.00 for its Gippsland towns (in 2006 dollars, GST exclusive)

Multinet agrees to this change and will make the necessary amendments.

2.2.6 Schedule 2—Ancillary Reference Service Prices

Multinet is required to change the 2008 tariff for reconnection in Schedule 2 of its Reference Tariff Policy to \$110.91 for its Gippsland towns (in 2006 dollars, GST exclusive).

Multinet agrees to this change and will make the necessary amendments.

2.2.7 Arrangements if Tariffs not Submitted or Approved

Multinet and SP AusNet are required to amend their respective Reference Tariff Policies to provide that if tariffs are not approved as compliant by 1 January then:

- if the price control formulae provide that tariffs will otherwise increase, on average, in nominal terms, then no change will be made to tariffs on 1 January

Multinet agrees to this change and will make the necessary amendments.

2.2.8 Arrangements if Tariffs not Submitted or Approved

Multinet and SP AusNet are required to amend their respective Reference Tariff Policies to provide that if tariffs are not approved as compliant by 1 January then:

- if tariffs would otherwise decrease, on average, in nominal terms, then a decrease to all tariffs will be made on 1 January.

Multinet agrees to this change and will make the necessary amendments.

2.2.9 Change in Taxes that Affect Revenue

Multinet is required to remove the phrase 'or the receipt of revenue in respect of the provision of Reference Services' in the definition of Relevant Tax in the Glossary.

Multinet agrees to this change and will make the necessary amendments.

2.2.10 Change in Taxes that Affect Revenue

Each distributor is required to amend the definition of Change in Taxes Event to the following:

a variation, or withdrawal or introduction of a Relevant Tax, or a change in the way or rate at which a Relevant Tax is calculated, which has a material impact on the costs to the Service Provider of providing the Reference Services or which has a direct and material impact on the revenue received (after payment of Relevant Taxes) by the Service Provider for providing the Reference Services.

Multinet agrees to this change and will make the necessary amendments.

2.2.11 Definition of Relevant Tax

The Commission invites Multinet and SP AusNet to amend clauses (a)(3) of their respective definitions of Relevant Tax to the following:

voluntary membership fees or voluntary contributions payable to membership bodies (that is, fees and contributions in respect of membership bodies which the Service Provider is not required by legislation or other Regulatory Instruments to join).

Multinet agrees to this change and will make the necessary amendments.

2.2.12 Length of the Fixed Period

Multinet and SP AusNet are required to amend the Fixed Period from the end of the Fourth Access Arrangement Period to the end of the Third Access Arrangement Period for the following Fixed Principles in the Reference Tariff Policy:

- Multinet: 7.2(a)(1), 7.2(a)(2), and 7.2(a)(5)

Multinet will make the necessary amendments.

2.2.13 Fixed Principles—Clause 7.2(a)(7)

Multinet is required to remove the following Fixed Principles:

- 7.2(a)(7) relating to negative carryovers.

Multinet rejects this amendment and will not make the necessary amendments.

Multinet is mindful that the operating and maintenance forecasts for the 2008–2012 period set out in the Final Decision are well below than that required to operate the business (see section 3 below for detailed explanations). As such it is expected that, in the outturn, Multinet's regulatory accounts will show expenditure well above the Commission's benchmarks.

Based on the approach in the Final Decision Multinet will potentially be penalised twice. Once for overspending against the benchmarks and then again in the following period in the form of a negative efficiency carry over. This is not a symmetrical outcome for the company and places Multinet in a position where it has to rely on the goodwill of the regulator rather than providing the company with certainty that it can at least recover its forecast costs.

2.2.14 Fixed Principles—Clause 7.2(a)(8)

Multinet is required to remove the following Fixed Principles:

- 7.2(a)(8) relating to the tax wedge.

Multinet agrees to this change and will make the necessary amendments.

2.2.15 Fixed Principles—Clause 7.2(a)(3)(H)

Multinet is required to remove the following Fixed Principles:

- 7.2(a)(3)(H) relating to capital expenditure incurred in relation to certain IT expenditure.

Multinet agrees to this change and will make the necessary amendments.

2.3 Part C-Terms and Conditions

2.3.1 Clause 7.3(e)

Multinet and SP AusNet are required to delete clause 7.3(e) of their proposed terms and conditions.

This clause is currently in our revised Access Arrangement and is technically compliant with the Gas Code. The Commission has given no valid reason why Multinet should remove it.

2.3.2 Clause 7.4(d)

Multinet is required to replace clause 7.4(d) of its proposed terms and conditions with the following drafting:

Subject to clause 7.5(c), if the Service Provider has undercharged or not charged a User for Distribution Services provided in respect of a Customer, the Service Provider may recover the amount undercharged or not charged to the User, however the User will not be obliged to pay such charges to the extent that the User is precluded from recovering those costs from the relevant Customers by operation of the Regulatory Instruments.

Multinet does not agree to the proposed drafting. The revised wording sets no timeframe so the retailer could, in every case, claim they were unable to recover the costs.

Multinet will adjust the timeframe to recover in order to be the same as the Retail Code, that being 9 months instead of 11 months.

3 Reasons for Price Changes

One of the amendments required by the Commission relates to the P(0) calculation of tariffs for the 2008 year and the X factor for the 2009–2012 period. Multinet does not accept the Commission Final Decision and proposes a P(0) change of -9.0 per cent for 2008.

This section of the response addresses the various required amendments and provides Multinet's reasons for not accepting the Commission's Final Decision. Also provided as part of this response is an Excel spreadsheet that details the calculations for calculating price changes for the 2008–2012 period.

3.1 Cost of Capital and Gamma

Table 3.1 below provides a summary of the Commission's Final Decision compared to parameters that Multinet believes are consistent with the Code as set out in its revisions.

Table 3.1: Summary of Final Decision

Parameter	Final Decision	Revisions	Comments
Risk free rate			
- Nominal risk free rate	6.05	6.05	Accept FD
- Inflation	2.70	2.60	Reject FD
Real risk free rate	3.26	3.36	Reject FD
Equity beta	0.7	1.0	Reject FD
Market risk premium	6.0	6.0	Accept FD
Gearing	60%	60%	Accept FD
Cost of debt			
- Debt spreads	202.0 bp	209.6 bp	Reject FD
- Debt raising	12.5 bp	12.5 bp	Accept FD
- CBA bias	0.0 bp	25.0 bp	Reject FD
Cost of debt	214.5 bp	247.1 bp	Reject FD
Real Vanilla WACC	6.20%	7.30%	Reject FD
Gamma	0.50	0.35	Reject FD

The remainder of this section 3.1 provides the Commission with reasons why Multinet does not accept the Commission's Final Decision in relation to Cost of Capital and Gamma.

3.1.1 Inflation

In its Draft and Final Decisions, the Commission recognised the existence of a bias in the market for indexed Commonwealth Government Securities by calculating the real risk free

rate using the nominal rate adjusted by a forecast of inflation. For the purposes of calculating the real risk free rate, the Commission's final decision has forecast inflation at a 2.70 per cent per year increase in the Consumer Price Index (CPI).

The Commission's 2.70 per cent estimate of forecast inflation is predominately based on the 10-year historical average of inflation, as shown in Figure 10.1 in the final decision. The Commission makes a number of assertions that it has also relied on distributor's evidence, statements of the RBA and Treasury, and views of financial forecasters however the Final Decision contains no evidence how this was applied. The only evidence presented is the historic CPI data.

Multinet submits that this value is biased upwards due to the impact of the introduction of the Goods and Service Tax (GST) in July 2000. A one-off increase in the observed CPI is apparent over 2000/01 and is clearly visible in the Figure 10.1 of the final decision. The effect of the introduction of the GST has been estimated to have increased the annual CPI by 3 per cent over 2000/01. Multinet therefore submits that, if the inflation forecast be based on the 10-year historic observations, the data should be adjusted for this one-off event. By not removing this event the Commission implicitly assumes that this event will occur again in the future. There is no evidence to suggest that this will occur and the Commission has erred by not removing the GST spike for the purposes of establishing a robust forecast for the 2008 - 2012 period. Once the GST effect is removed, the 10-year average CPI from December 1997 to 2007 is 2.40 per cent.

Multinet has also considered forward looking evidence to derive its estimate of forecast inflation.

In response to the draft decision, Multinet sought expert advice on an appropriate forecast of inflation. CECG¹ and NERA² forecast the inflation rate over the 10 years to be between 2.50 per cent and 2.60 per cent. This analysis is the most robust estimate available on the 10 year forecast of inflation as it provides a forward looking view. Unlike the Commission's analysis, it does not consider evidence which is not available in the November 2007 sampling period. The Commission considered the RBA's inflation forecasts contained in the February 2008 Statement on Monetary Policy released on 7 February 2008. The forecast inflation rate should only incorporate the information available over the 20 day sampling period. The February data should be ignored as it was released months after the end of the November 2007 sampling period, the period agreed between the distributors and the Commission that would be relevant for these purposes.

Multinet has attached as an Appendix a response from CECG and NERA on the Commission's treatment of their forecasts of inflation. NERA agrees that the use of the historical averages unadjusted for the introduction of the GST is inappropriate. NERA also notes that all estimates of the 10-year inflation rate are below the ESC's estimate.

In conclusion, Multinet submits that the best forecast of inflation derived on a reasonable basis over 10 years is 2.50 per cent to 2.60 per cent. Multinet has calculated the real risk free rate using an assumed inflation rate of 2.60 per cent.

¹ CECG 2007, *A methodology for estimating expected inflation*, 26 October 2007.

² NERA 2007, *ESC draft decision: inflation expectations, a report for APIA, ENA and ETNOF*, 29 October 2007.

3.1.2 Equity Beta

On the advice of Allen Consulting Group (ACG), the Commission's Final Decision adopted an equity beta of 0.7.

Multinet submits that the Commission's decision is not sustainable because it has dismissed the extensive and well-researched expert reports provided to it on the basis of analysis by Allen Consulting Group and an incorrect application of the Code in respect of the report by CECG.

Moreover, based on the advice of its expert consultants, Multinet has demonstrated that reliance on ACG's analysis of market data represents a use of unreliable data.

The Commission's decision does not accurately reflect returns to equity required by the market for gas distribution businesses as required by s8.30 of the Code.

Multinet maintains that equity beta should be valued at 1.0. There is nothing in the analysis supporting the Final Decision (either by ACG or within the Final Decision itself) that provides a sound basis for rejection of that value and the acceptance instead of a value other than 1.0. Multinet demonstrates this in the material set out below and through CECG's, NERA's and SFG's reviews of the Final Decision and the ACG report, which are attached. It would be unreasonable and contrary to the Gas Code for the Commission not to approve an equity beta of 1.0 given the significant weight of supporting expert evidence before it.

In response to the draft decision, Multinet sought expert financial advice from CECG³ and SFG⁴. Multinet notes that NERA⁵ provided advice on the issue to the Energy Networks Association, the Australian Pipeline Industry Association and Electricity Transmission Network Operators Forum. These pieces of advice used a range of different approaches to assess the Commission's argument in Draft Decision that equity beta lies between 0.5 and 0.8 as proposed by ACG. What clearly emerged from each advice was that the Draft Decision's range does not accurately reflect the cost of equity in the market for funds and that an estimate of the equity beta for the benchmark gas distribution business of 1.0 is the best estimate on a reasonable basis.

3.1.2.1 CECG Report

In response to CECG's comprehensive analysis of the capital asset pricing model (CAPM) the Commission has formed the view that the analysis cannot be applied because it requires the use of a version of the CAPM other than the Sharpe CAPM. The rationale for this prohibition is that the Code and the Fixed Principles require the use of the Sharpe CAPM. The Commission has therefore concluded that the evidence that flows from examination of the Black and Merton CAPM's cannot be applied to estimating the prevailing cost of equity using the Sharpe CAPM.

³ CECG 2007, *Estimating relative risk in the market for funds*, 26 October 2007.

⁴ SFG 2007, *Equity beta estimates for Victorian gas distribution businesses; a report prepared for Envestra, Multinet and SP Ausnet*, 25 October 2007

⁵ NERA 2007, *Equity beta for gas distribution, a report prepared for APIA, ENA and ETNOF*, 29 October 2007.

The Commission's reasoning is in error because:

- The Code does not require the use of the Sharpe CAPM. It simply requires the use of the CAPM.
- Similarly, the Fixed Principles do not require the use of the Sharpe CAPM. They simply require the use of the CAPM.
- More importantly than either of the points above, and even if they were not true, Multinet has not proposed nor did CECG recommend that Black or Merton CAPMs be used. CECG has used the more accurate and superior Black and Merton CAPMs to provide insight into the application of the Sharpe CAPM. The result is a significantly more reliable estimate of the equity beta for the Sharpe CAPM. Through the information from its analysis of the Black and Merton CAPMs CECG has demonstrated that an equity beta of 1.0 is consistent with the Code.

CECG has provided a brief summary report which sets out the errors in both ACG's and the Commission's assessment of the CECG report. This report is attached as an Appendix. CECG concludes that even though the Commission does not dispute the findings in its October 2007 report, the Commission does not have regard to this evidence..

3.1.2.2 SFG Report

SFG's review of the Final Decision demonstrates that the February 2008 ACG Report and the Commission's analysis consists of an unsupported dismissal of the significant evidence Multinet put forward, based on the data that the ACG relied on its August 2007 report, which lacks quality and reliability. ACG has provided little critical analysis of the issues and no evidence why an equity beta of 1.0 is unreasonable

In addition to placing weight on statistically unreliable beta estimates, SFG concludes that the Commission has erred in not considering or responding to analysis contained in the October 2007 SFG report.

SFG's response to the Final Decision and the February 2008 ACG report is attached as an Appendix to this submission.

3.1.2.3 NERA's Report

Similarly, NERA's review of the ACG report and the Commission's analysis of its report on equity beta is an appendix to this submission. NERA concludes that both the ACG report and the Final Decision have misapplied the NERA report.

In particular, the ACG Report and the Final Decision:

- do not consider how the NERA analysis of estimates of the cost of equity determined by US regulators provide substantial information about the nature of the cost of equity for distribution businesses and in particular implied actual equity betas; and
- incorrectly dismisses the data problems identified by NERA in relation to the historic beta estimates made by ACG's first report.

3.1.2.4 Conclusion

Multinet resubmits that the best estimate on a reasonable basis of the equity beta is 1.0. The material submitted by Multinet in response to the draft decision has not been adequately addressed and still stands as a robust body of evidence supporting an equity beta of 1.0. Conversely, the evidence relied on by the Commission is unreliable. There arose no occasion for the Commission to exercise its discretion to fix its value for the equity beta.

3.1.3 Debt Margin

The Commission's final decision was to value the debt margin at 214.5 basis points (bp). This value was based on the costs for a BBB+ rated infrastructure business raising 10 year debt. In response to the final decision, Multinet submits a debt margin of 247.1 bp as set out in Table 3.2.

Table 3.2: Components of the Debt Margin

Component of the Debt Margin (basis points)	Multinet revised proposal	Final Decision	Multinet Response to Final Decision
Raw debt premium	140.66	202	209.6
CBASpectrum adjustment	25	0	25
Adjustment for absolute bias	-37	0	0
Debt raising costs	12.5	12.5	12.5
Total	141.2	214.5	247.1

The Commission engaged ACG to estimate the debt margin for the 20-day sampling period in November 2007. While Multinet supports the Commission's decision to allow 12.5 bp for debt raising costs and its position on the assumed credit rating and debt term, Multinet has concerns with some aspects of the calculation of the total debt margin.

Firstly, Multinet notes that the Commission has calculated the debt premium after considering corporate bonds with terms to maturity significantly less than 10 years. Multinet has calculated the fair value yield on BBB+ corporate debt with a 10-year maturity to be 209 bp for the November 2007 sampling period. The data was obtained from CBASpectrum.

Secondly, the Commission rejected the underestimation bias in CBASpectrum data after considering *short term* bonds. This is inappropriate as the bias was demonstrated to exist in low rated (BBB+) long dated (10 years) bonds. Multinet therefore submits that if the debt premium is observed using CBASpectrum data, an allowance of 25 bp should be added to compensate for the underestimation bias or the current level of the bias should be measured using long dated low rated bonds.

Multinet has attached as an Appendix a response from NERA on the final decision for the debt margin.

Multinet therefore submits that, for the purposes of the further final decision, the debt margin is valued at 247.1 bp.

As noted above, Multinet's view is that the CPI forecast should be measured by reference to the 20 day sampling period in November. However, if the Commission's view prevails that the CPI forecast can be updated to February then so should the other components of the market parameters. Banking sector estimates are that the impact on borrowing costs are of the order of 50 basis points. This information indicates that a reasonable estimate of the debt margin is likely to at least be as high as Multinet has estimated it.

3.1.4 Gamma

The Commission's final decision values gamma at 0.5. The distributors jointly sought advice from SFG⁶ on an appropriate value for gamma in their response to the draft decision. The Commission has rejected Multinet's proposal for a gamma of 0.35.

The Commission has considered evidence from Lally in its discussion on the views of experts. This is not appropriate as Lally does not quantify gamma using the same framework as other experts, rendering his views incompatible.

Multinet has attached as an Appendix a response from SFG on the Commission's treatment of its analysis of gamma. SFG concludes that the Commission has:

- incorrectly relied on outdated studies from Beggs-Skeels and Hathaway-Officer rather than the October 2007 SFG report which applies the same methodology and type of data. The Commission ignored the October 2007 SFG in spite of the fact that the full data set and supporting computer programs were provided to the Commission;
- inadequately considered that most financial practitioners make no adjustment for the value of franking credits;
- relied on estimates provided by Lally which are based on an economic framework that is inconsistent with CAPM; and
- incorrectly suggested that foreign investors may be willing to accept a lower required return than that required by Australian investors due to diversification benefits.

In accordance with the views of SFG, Multinet resubmits that gamma should be valued at 0.35. The material submitted by the distributors in response to the draft decision has not been adequately refuted and still stands as a robust body of evidence supporting a gamma of 0.35.

In addition to these arguments Multinet re-affirms that there is no one correct answer and there are a number of approaches that can be regarded as reasonable basis for estimating gamma. Moreover the estimate adopted from the range suggested by the evidence and basis adopted by Multinet is one that balances the factors under s8.1 of the Code reasonably, whereas adopting 0.5 would not. This has been noted by many Australian regulators.

⁶ SFG 2007, *The impact of franking credits on the cost of capital of Australian companies, a report prepared for Envestra, Multinet and SP Ausnet*, 25 October 2007

The Commission's role is not to establish what it considers to be the correct answer but to determine if the value proposed by Multinet does not comply with the Code. Multinet re-submits that the material presented with its AAI, its response to the draft decision, the attached report from SFG entitled 'The impact of franking credits on the cost of capital of Australian companies', together with the fact that the value of 0.35 has been adopted by energy regulators (as noted by the Commission) and was recently accepted by an appeal panel in South Australia under the Gas Code regime, establishes that the Multinet proposal of 0.35 is reasonable and conversely does not allow the Commission to conclude that the value proposed by Multinet of 0.35 does not comply with the Code. Accordingly, the occasion for the exercise of the Commission's discretion did not arise.

3.2 Operating Expenditure (non-capital costs)

3.2.1 Overall approach to operating expenditure forecasts

Multinet does not accept the Commission's Final Decision for Operating and Maintenance forecasts for the 2008 – 2012 period. The Commission's process for establishing forecasts has been consolidated by applying a suite of individual analyses that in the whole are not consistent and do not provide Multinet with a stream of revenue that allows it to recover its total costs.

An approach that relies on individual components without consideration of the relationships to each other or the total forecast generates significant risk of internal inconsistencies. The Commission has applied this approach without due consideration for the overall impact or consistency in the process, and accordingly the forecast derived is not a reasonable one.

Multinet notes that the Code requires a forecast of non-capital costs for the five year period. It does not require a determination of non-capital costs in the base year, nor a determination of PFP or rate of change. Multinet is concerned that the emphasis on these component analyses in the Final Decision, without due regard for their interdependencies and the overall impact, effectively treats these component analyses as an ends in themselves, not as means to an end. It is noted that this methodology is specific to the Commission and is not adopted by other regulators or businesses in forecasting non-capital costs. This leads to greater risk of error due to a lack of testing over time.

Despite Multinet's reservations regarding the Commission's methodology, the Company is prepared to work with the Commission's approach, being carefully to apply the methodology in a way that ensures the individual components are applied consistently and are viewed in an overall context.

A summary of the Commission's methodology is provided below:

1. Establish base year costs (2006) sourcing regulatory accounting information and adjusting for items at the Commission's discretion. In Multinet's case the base year costs have the following components;
 - a. OSA costs;
 - b. EPG costs; and
 - c. other costs incurred directly by Multinet;

2. These costs are then rolled forward to 2007 by applying the efficiencies deemed should have been incurred in 2007;
3. This cost forecast is then adjusted for scope changes applicable to the next period; and
4. A rate of change based on industry wide forecasts of labour rate changes, productivity improvements (PFP) and CPI is estimated, and applied to the 2007 forecast to roll it forward to the years 2008 - 2012.

Multinet has not accepted the Commission's approach in respect of steps 1b, 1c, 2 and 4 above. Multinet's response to these issues is set out below.

3.2.2 2006 Base

Multinet does not accept the Commission's Final Decision in relation to the calculation of base opex, as there is an oversight in the calculation of the operating (non-capital) cost expenditure allowance in the Final Decision. The Commission has determined the 2006 base year by adding EPG and OSA fees and have neglected to include other direct costs.

Unlike its Draft Decision, the Commission's Final Decision calculation of Multinet's total 2006 opex base has taken into account only the EPG Fee and the OSA Fee. It has omitted inclusion of Multinet's direct costs (including licence fees), an amount of \$2.8 million, in its build-up of Multinet's operating cost base for 2006. This is evident from a reconciliation of material in the Final Decision and the Commission's subsequent clarification of its calculations as set out below, and in the appendices.

Based on Table 5.2 of the Final Decision and an e-mail from Commission staff on 19 March 2008, the components of the operating cost base in 2006 that the Commission determined are set out in Table 3.3 below.

Table 3.3: Commission's calculation of base opex (\$m in July 2006)

Description	Amount
EPG Fee	2.66
OSA Fee	30.55
2006 base costs including licence fees	33.21

This reconciles to other parts of the Final Decision (on pages 223 and 579) in which the Commission has deducted \$6.79m from the reported 2006 costs as detailed in the Table 3.1 below. The information in this table has been sourced from the Commission's Final Decision model.

Table 3.4: Final Decision Summary – Base Opex (\$m in July 2006)

Description	Amount
2006 reported costs	40.04
Less: ESC adjustment	-6.79
Less: rounding	-0.03
2006 base costs including licence fees	33.21

Multinet accepts the Commission's calculation of the OSA fee and is not challenging this point. An appendix to this submission provides a detailed table that confirms the Commission's calculation as being consistent with the remainder of the decision, and confirms that the Commission has omitted approximately \$2.8 million of direct costs in the 2006 base year. These direct costs are included in Multinet's 2006 Regulatory Accounts and have been signed off by our auditors Ernst & Young.

Multinet has provided details of its direct costs previously to the Commission on several occasions. Firstly, Multinet's Access Arrangement Information dated 30 March 2007 makes reference to direct costs on pages 45, 46 and table 5.20 on page 73. Further, on 2 May 2007, the Commission wrote to Multinet seeking (amongst other things) clarification regarding the nature of the direct costs. Multinet provided the following information in response dated 15 May 2007:

Other direct costs are forecast to be approximately \$2.8m per annum with a spike in 2012 increasing the annual expenditure to \$3.7m.

Firstly the spike in 2012 is entirely due to the costs of revising the Access Arrangement in the final year of the period. There are no Access Arrangement revision costs in 2006 and are therefore not included in the base.

The bulk of the \$2.8m is the insurance cost of Multinet. The major insurance categories include:

- a. public liability;
- b. property; and
- c. directors and officers;

Other costs also include audit of statutory and regulatory accounts, professional and consulting fees, and memberships of ESAA etc.

The Commission's Draft Decision did not take issue with these direct costs and included them in Multinet's opex cost base for 2006. It was on this basis that Multinet made no further supporting submissions on this matter. Multinet can make available all the source documentation to support the information provided above.

The Commission has wrongly calculated Multinet's opex cost base for 2006 and this has flowed through to errors in the calculation of its 2008-2012 operating (non-capital) cost expenditure allowance by not including these direct costs. It is a simple oversight, which Multinet anticipates the Commission will readily correct in the Further Final Decision.

3.2.3 Assumed 2007 Efficiency Carry over

Multinet does not accept the Commission's Final Decision in relation to its assumed 2007 efficiency. The Commission has determined its forecast 2007 efficiency by reference to the efficiency assumed for 2007 in the 2003 GAAR decision. That decision (made in October 2002) assume that Multinet would reduce its operating costs from \$38.1m in 2006 to \$37.7m in 2007 (both in 2001 dollars). When converted to 2006 dollars, that is equivalent to Multinet reducing its operating costs from \$43.6mm in 2006 to \$43.2m in 2007.

Since October 2002, there have been a number of changes in circumstances that the Commission has not taken this into account in its Final Decision. The Commission's determination indicates an equivalent 2006 operating costs for Multinet of \$32.5m (being the \$38.55m less \$6.0m of FRC costs shown on Table 7.5). This is some \$11.1m lower than the 2006 operating cost assumed when the Commission determined in October 2002 that Multinet should reduce costs by a further \$0.4m.

Multinet concludes that the \$0.4 m of efficiencies that the Commission had previously should be achieved in 2007, have in fact been achieved well ahead of schedule, and that the Commission has no basis to now apply the same \$0.4m of efficiencies, given the early achievement of efficiencies that we now know has occurred, and to do so would be an inconsistent use of the 2003 determination, and in error.

The Commission's interpretation of earlier response by Multinet is incorrect. Multinet has never considered the inclusion of the 2007 efficiency reasonable. As demonstrated in earlier submissions⁷, Multinet has made efficiency gains in total in excess of those forecast for the 2003–2007 period. The Commission has double counted the efficiencies by again deducting the 2007 figure even though the saving has already been made. There is no factual basis for the deduction.

3.2.4 Opex base for the OSA in 2006

In the Final Decision, the Commission's determined its own estimate of Multinet's OSA cost base for 2006 rather than except Multinet's estimate. Both the Commission and Multinet used the OSA cost base to forecast future opex costs, albeit for different reasons.

Table 3.5 shows a comparison between the Commission's determination of the 2006 OSA cost base for 2006 and Multinet's.

⁷ Section 7.9 of Multinet's response to the Draft Decision

Table 3.5: Adjustment of the OSA cost base for 2006 (\$m in July 2006)

The Commission's Adjustment		Multinet Adjustment	
Reported OSA fee in 2006	xx.xx	Reported OSA fee for 2006	xx.xx
Less: AAM margin	xx	Less: one-off improvement in efficiency ⁸	xx
AAM's cost to provide its services	xx.xx		xx
Less: FRC costs	xx	Less: FRC costs	xx
Add: annual synergy	xx		xx
Less: ESF costs excluded	xx		xx
Opex base for OSA for 2006	xx.xx	Opex base for OSA for 2006	xx.xx

Multinet does not understand why the Commission has concluded that Multinet's estimate does not comply with the Gas Code, and has chosen to replace Multinet's estimate with its own, when the difference is so small. Due to the materiality of the difference Multinet will accept the Final Decision relating to the calculation of the OSA, subject to correction explained in section 3.3.1 above.

In doing so, however, Multinet also wishes to make the following points that put further into doubt why the Commission can conclude that Multinet's estimate does not comply with the Gas Code:

- *Incentive to negotiate the lowest cost* – The Commission's view that Multinet did not have or respond to its incentive to negotiate the lowest sustainable cost is clearly inconsistent with paragraphs 13 to 21 of Mr Lowe's affidavit.
- *Transparency of cost information* – While the OSA does not compel AAM to provide Multinet with its cost information, AAM provided this information to Multinet and the Commission voluntarily. In the light of this information, Multinet has maintained its view that its forecast OSA costs reflect it securing an efficient commercial outcome from its OSA renegotiation in 2008.
- *Excluded ESF costs* – The ESF functions that AAM conducts are not duplicated services to Multinet. They are Alinta's overheads of doing business and are part of AAM's legitimate cost base. NERA confirmed that a proportion of a contractor's common costs should be included in its costs base when seeking to establish an in-house counterfactual.⁹
- *Synergy calculation* – The Commission did not take account that AAM's estimate of its synergies is a minimum estimate. Other synergies exist but they are too difficult to calculate. NERA also highlighted this challenge.

⁸ Multinet's Access Arrangement Information, 30 March 2007, pages 46-7.

⁹ NERA, Treatment of outsourcing arrangements, October 2007, pages 79-81.

For these reasons, Multinet maintains that its view that the Commission has not established that its approach to forecasting its OSA costs for 2008-2012 is not Code compliant.

3.2.5 EPG Fee

The Commission has chosen to reject Multinet's proposal and amend the EPG fee from \$4.9 million per year to \$2.7 million per year. The basis of this amendment is made up of specifically removing:

- \$1.5 million per year for fees paid by the DUET trust to its Responsible Entities where the underlying costs cannot be readily identified; and
- \$0.8 million per year for fees paid to Alinta for which there is no basis on which such an allocation could form part of the EPG fee.

The basis for these exclusions appears to be that the Commission has only allowed the EPG fee to the extent it is supported by costs which meet the criteria of the ESC's regulatory accounting framework. This framework differs to Accounting Standards in that it requires the underlying costs of all related parties to be accounted for or otherwise identified, including the costs of related parties that are not members of the same group as Multinet.

This framework is unworkable in this regard because neither Multinet nor its parent entities have control that enables them to either access or mandate that cost information be extracted and presented for regulatory purposes from Macquarie, AMP and Alinta.

Multinet rejects the Final Decision and has included the original \$4.9m pa in calculating operating costs for the 2008–2012 period.

3.2.6 Other Direct Costs

Due to the incorrect calculation of the 2006 base (explained in section 3.3.1 above) the Final Decision has excluded legitimate actual costs incurred by Multinet. There has been no explicit explanation provided in the Final Decision for the removal of these costs; rather it appears to relate to a calculation error that Multinet anticipates the Commission will correct when making its Further Final Decision. Actual details of the direct costs have previously been provided to the Commission.

3.2.7 Rate of change – partial factor productivity

The Commission's approach adopted in the Final Decision to forecasting operating expenditure includes an estimate of the 'rate of change', which is applied to escalate recurrent operating expenditure for the effects of price changes, output growth and productivity.

It is noted that the Code does not require, or in fact provide for, such a rate of change calculation. What the Code requires is a forecast of *overall* non-capital expenditure for *Multinet*. The Code does not envisage the disaggregating of expenditure forecasting into independent and complex underlying analyses which the Commission's approach gives rise to. That approach leads to outcomes which fail to meet the requirements of the Code by inconsistently applying benchmarked industry average rate of change to company specific 2006 costs.

Multinet has provided extensive benchmarking analysis that supports its assertion that Multinet is operating at best practice levels of cost efficiency, prior to the Commissions imposed operating expenditure cuts. The Commission appears to endorse this benchmarking data when it states that Multinet is, in a comparative sense, operating efficiently (Multinet notes that efficiency cannot be anything but a comparative concept).

Nevertheless, the Commission then makes very significant reductions to Multinet's base operating expenditure based on firm specific analysis of historical costs primarily driven by after the event changes to accounting and cost recording requirements. These cuts are not based on consideration of benchmarking or consideration of where Multinet operates relative to the efficiency frontier. The Commission has had no regard to these Multinet specific outcomes when considering the prospects for future productivity but rather simply applies a benchmark industry average to a firm specific starting point.

The overall effect is to impose a higher productivity requirement for Multinet than that for the other distribution businesses which have higher base costs to start with. Such an outcome simply doesn't make sense, highlights the risks inherent in the Commission's methodology and shows how far the Commission has strayed from the requirements of the Code.

Given the benchmarking data provided, the Commissions recognition of Multinet's relative efficiency, and the Commission's deeming of a further 15+% cost cut on the already efficient level, Multinet considers that it is reasonable to argue that:

- The determination of PFP by the Commission is inconsistent with the base year cost determination, and will lead to an erroneous opex forecast;
- The imposition of any level of productivity improvement (PFP) in the opex forecasts represents a "double dip" vis-à-vis the 15+% cut to the base year cuts, relative to the industry benchmarks; and
- When considering efficiencies to be achieved/productivity, the 15+% base year cost cut can only be viewed as an early recognition of future efficiencies.

Given the above it appears reasonable to argue to that the PFP should be set to zero, if the 15% base year cut is to remain. Multinet notes that throughout the GAAR process when it sought expert analysis on PFP and put forward PFP assumptions (of greater than zero) in its proposed Access Arrangement, it has done so on the assumption that the PFP is applied to a start point on the efficiency frontier – not 15% ahead of it.

That said, Multinet has not adopted a PFP of zero, but has assumed the 1.41% that it has previously proposed, even given the lower start point (base year cost). This approach has been taken to ensure that Multinet's approach cannot be argued at being at the low end of the reasonable range, but rather is at the middle or the high end of the range, when all things are considered (i.e. an assumption that is unfavourable to Multinet).

Given the inherent difficulty in the task of forecasting the rate of change, Multinet responded reasonably to the Draft Decision by seeking the views of a third independent expert, Geoffrey Horton, who has very substantial experience as an economist and a regulator. Mr Horton's expert opinion is that an aggregate approach to rate of change would be reasonable, and in some situations could yield a more accurate forecast than the disaggregated approach adopted by the other two experts. Multinet acted reasonably in accepting Mr Horton's opinion and in taking a middle ground between the PEG and Meyrick views.

The Commission has erred in rejecting Multinet's proposal in favour of its own expert. The Commission did not independently test PEG's advice, even though the Commission had received two independent expert reports, from Meyrick and Horton, which very strongly criticised PEG's analysis and recommendations in relation to partial factor productivity (PFP), which is an important component of the rate of change calculation. If the Commission had properly tested PEG's advice, the Commission would have concluded that Multinet's approach in giving some weight (but not entire weight) to PEG's report was reasonable. PEG's analysis is largely based on companies operating in the United States and therefore at best it is only of limited relevance to Multinet's forecast operating expenditure. The Commission is in error to conclude that PEG's report provides the best estimate of PFP.

To remedy the Final Decision, Multinet's view is that the Commission should adopt Multinet's proposal of a PFP of 1.41%. Notwithstanding this suggestion, Multinet notes that the very substantial reduction imposed by the Commission on Multinet's base year costs has the overall effect of requiring Multinet to deliver an even greater PFP than contemplated by PEG (as discussed above). If PEG had taken due account of the reductions imposed by the Commission to Multinet's base year costs, the appropriate PFP figure for Multinet would be close to zero. Instead, PEG has erroneously examined the PFP estimation on the basis that there are no other efficiency improvements imposed on Multinet. The Commission's overall approach, therefore, is in error and inconsistent with the Code.

It must also be noted that Multinet has not received sufficient supporting information (such as datasets) from PEG to verify that its results for Multinet are accurate. On this basis alone, it would be improper for Multinet to have given full weight to PEG's results.

Multinet has obtained two further independent expert opinions from Meyrick and Geoffrey Horton that comment on PEG's final report. These expert opinions are attached as appendices. Multinet would like to draw the Commission's attention to three particular issues in these independent expert opinions:

- Meyrick has identified obvious numerical errors in PEG's final report. This confirms Multinet's view that it is better not to rely on a single opinion as the Commission has done.
- Both experts' confirm that PEG's coefficient for the capital stock has the wrong sign. This fact appears to be accepted by all three experts, including PEG. However, PEG refuses to concede that this is an issue of concern on the ground that similarly incorrect results have been obtained by other academics. This is an unconvincing argument.
- Both experts state that PEG's final report either obfuscates or is disingenuous. Horton comments that instead of addressing the issues he has raised, PEG has challenged Horton's competence on the basis of an almost farcical discussion of some minor comments. These are serious comments that confirm Multinet's view that it is wrong to rely entirely on PEG's work as the Commission has done.

In light of these independent expert opinions, Multinet reconfirms its view that the Commission is in error to rely entirely on PEG's findings. Instead, it is better practice and consistent with the Code to steer a middle ground between the three expert opinions.

Accordingly, and despite the serious challenges to PEG's work, Multinet had regard to the divergent views of PEG, Meyrick and Horton and, by so doing, proposed a rate of change that represented the best estimate arrived at on a reasonable basis. In fact, PEG's earlier report to the Commission adopted a labour forecast that similarly combined two forecasts of labour costs, one forecast from BIS Shrapnel and one from Access Economics. PEG is inconsistent to now argue that Multinet should not be able to adopt a similar approach in respect of PFP.

In summary, the Commission's task is to determine whether the overall forecast of non-capital cost is compliant with section 8.37 of the Code. It has not addressed that task.

Moreover, in relation to the estimate of PFP growth, it must be acknowledged that there is no single correct answer. In making its decision, the Commission has not assessed PFP for Multinet with any reference to how the base year costs adopted for Multinet compares to the efficiency frontier, and has not shown Multinet's estimate falls outside the range of choice reasonably open having regard to the diversity of (strongly-expressed) views put by the three experts and the complexity and uncertainty of the estimation process.

Multinet therefore does not accept the Commission's Final Decision in relation to rate of change and PFP for the reasons outline above.

3.2.8 Scope changes

The Commission has chosen to accept Multinet proposal relating to scope changes for the Final Decision. Multinet therefore accepts the Final Decision.

3.3 Efficiency Carry Over

Due to the incorrect removal of other direct costs from the 2006 base the efficiency carryover amount calculated by the Commission will require correction. The effect will be to reduce the carry over amount. Details are included in the model included as part of this response.

3.4 Network Capital

The Commission has largely accepted Multinet's revised proposal which is a positive outcome. However, for the record, there are some aspects of the Final Decision where the Commission has chosen to not accept Multinet's proposal and substitute its own forecasts. In some cases the change relates to difference in unit rates and in others the express disallowance of specific projects.

Multinet accepts that the Commission has discretion when approving Access Arrangements however the detail of rejecting individual projects is not a good precedent for regulators to set. It effectively steps in the shoes of the business and makes decisions that it is not qualified to make. In the case of these individual projects Multinet still maintains that these are required projects however due to the materiality accepts the overall network capital forecasts as being reasonable.



3.5 Other Capital

The most significant component of this category of expenditure relates to information technology systems. The Commission has significantly increased the allowance proposed in its Draft Decision which is pleasing to Multinet. Multinet is now able to fund most of its IT expenditure for the 2008–2012 period.

The Commission has again not allowed specific capital items. In this case it relates to system requests and infrastructure replacement. These are all necessary activities and the rejection of these activities is not consistent with replacing and maintaining infrastructure at acceptable levels.

Despite this however Multinet accepts the Commission's Final Decision.

3.6 UAFG

The Commission has chosen to apply an average of the 2003–2006 actual UAFG results when establishing a benchmark for 2008. The UAFG benchmark for 2008 is therefore 3.3 per cent. This approach places little emphasis on the actual UAFG experienced at the moment which is 3.8 per cent. It is unclear why the Commission does not propose a similar approach to establishing UAFG benchmarks as it does for establishing operating cost forecast i.e. take the latest actual number and adjust for actual conditions.

There has been significant emphasis placed on the UAFG reconciliation in recent years which has been the main contribution for increasing the rate. As explained in Multinet's response to the Draft Decision the measurement of UAFG has been unreliable and mostly unrelated to the actual leakage of gas. Billing errors are more a source of UAFG movements than leaking pipes. Multinet proposed to keep the current benchmark of 3.6 per cent for these reasons.

The benchmark established in the Final Decision is forecast to cost Multinet approximately \$400k per year in payments to the retailers. This is entirely due to the starting benchmark being calculated using averages. These costs cannot be recovered in the tariffs and is therefore inconsistent with the principles in section 8.1(a) of the Code that Multinet be provided with the opportunity to earn a stream of revenue that recovers the efficient costs of delivering the reference services.



3.7 Total Revenue Summary

Table 3.6: Total Revenue

Description	Final Decision	Response
Cost of Capital	297.8	334.5
Depreciation	220.3	220.3
Operating and Maintenance	196.5	229.4
Efficiency carryover	35.3	32.7
Tax Wedge	22.0	36.8
Total Building Block Costs	771.9	853.6
P(o)	2.5%	-9.0%
X factor	0%	0%