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Via email

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cc Chris Pattas, Scott Sandles, AER

Dear Mr Pierce

Jemena supplementary submission to consultation paper—Cross period revenue smoothing (gas) – GRC0043

Jemena Gas Networks (NSW) Ltd (**JGN**) appreciates the collaborative approach of the Australian Energy Regulator (**AER**) throughout through this rule change process which aims to minimise price volatility for our customers.

We have considered the issues raised by the AER's recent submission. Having discussed these further with the AER, we would like to provide our views on the two suggested amendments raised.

In summary:

- *Revenue recovery principle*—we do not consider a revenue recovery principle is required. The AER needs to adopt consistent approaches to the adjustment determination (this rule change proposal) and its remade decision (outside the scope of this proposal). The AER's approach to the remade decision is not currently enhanced by the inclusion of a revenue recovery principle and its ability to make a decision in customers interests is not reduced—as is the case with JGN's proposed rule. Including this principle risks introducing ambiguity to the rules and detract from its simplicity.
- *End date*—We are open to extending the end date for the AER to make an adjustment determination by a month to 1 April 2019. However, any date after this would either not allow enough time to finalise prices for 2019-20 or would make this a different and more complex rule.

The remainder of this letter provides further explanation of these positions.

Revenue recovery principle

The AER proposed adding a 'revenue recovery principle' to the proposed rule. This has the aim of ensuring JGN only recovers the revenues it is entitled to recover.

JGN agrees it should not be allowed to recover more revenue than it otherwise would have been able to recover across the current (2015-20) and next (2020-25) access

arrangement periods. When these periods are looked at as a whole, there should be no windfall gains (or losses) under JGN's form of control.

Our rule change proposal addresses this concern the NPV neutrality requirement

Protection against windfall gains or losses is addressed through the core principle underpinning JGN's proposal. This is reflected in our proposed drafting that ensures any cross-period smoothing must be net present value (NPV) neutral.¹

Potential for windfall gains under a weighted average price cap (WAPC) needs to be addressed differently to revenue caps

JGN notes that a revenue recovery principle was proposed by the AER for the NSW/ACT electricity participant derogations and included in the AEMC's final rule. It was intended to address specific concerns relating to those derogations. JGN's proposed rule is drafted differently and is much simpler.

The AER submission on the draft electricity participant derogations identified the risk that certain defined terms in those draft rules could be interpreted in a way that resulted in a distributor earning windfall gains or losses under the price controls in place²— that is a revenue cap in NSW and average revenue cap in ACT.

WAPC does not intend for expected (forecast) and actual revenues to align

The weighted average price cap (WAPC) allocates JGN with volume risk. We agree with the AER that risk allocation should be preserved.³ The concept of windfall gains and losses under a WAPC is less clear-cut than the issues the AER identified under a revenue cap. This is preserve the allocation of risk. It is especially so when viewed across both access arrangement periods and moving revenue between them.

A WAPC will always result in a difference between outturn revenue (accounting for the actual volumes which have arisen) and expected revenue (which is calculated on a forecast volumes basis). This provides JGN financial incentive to operate in a manner consistent with customers interests. This makes up part of the regulatory contract between JGN and customers.

The NPV neutrality requirement is normally met on a forecast basis

We had always assumed that JGN would ensure NPV neutrality on an expected (using forecast volumes) basis. This is the approach which has been used to ensure NPV neutrality in previous remittal processes. The difference in our case is that we are seeking to smooth the impact on prices over two regulatory periods.

¹ As currently drafted under JGN's proposed rule, if the AER makes an adjustment determination, the design of the reference tariff variation mechanism for the subsequent access arrangement period must be adjusted so as to perfectly offset (in NPV terms) any increase or decrease to total revenue for the 2015 access arrangement period under the adjustment determination. See JGN Rule Change Proposal, p 12; proposed sub-rule (7).

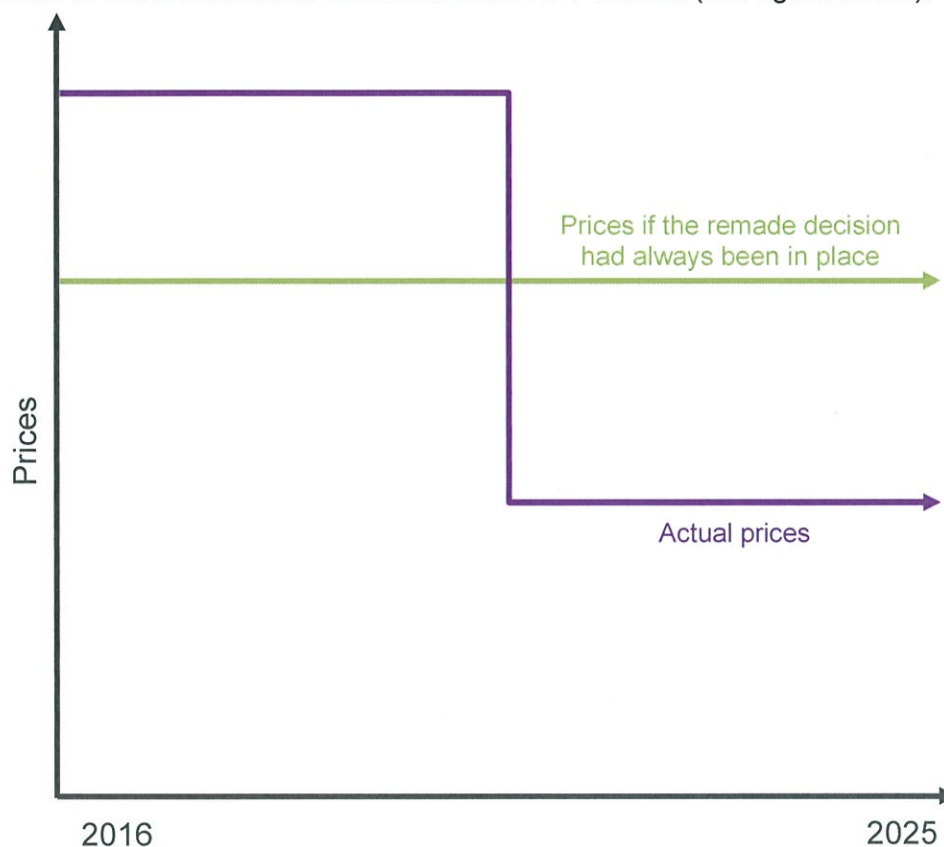
² AER, NSW and ACT revenue smoothing rule change: AER submission to Australian Energy Market Commission draft rule, June 2017, p 8 and sections A.1 and A.2.

³ AER submission, p 4.

Ensuring NPV neutrality using forecast volumes is also the approach set out in both the National Gas Rules⁴ and National Electricity Rules⁵ to ensure that expected revenue aligns with the revenue building blocks.

By virtue of changing prices, smoothing will create different actual revenues

We recognise that moving revenue between regulatory years changes what prices would have been in place. In JGN's case, actual prices, for both the 2015-20 and 2020-25 periods will be different to what they would have been if the AER's remade decision had always been in place.⁶ Actual prices have initially been higher, but will later be lower to ensure JGN and consumers are NPV-neutral (see figure below).



Ensuring NPV neutrality using forecast volumes does change when any over-recovery is exposed to volume risk. Using forecast volumes means that we are exposed to volume risk when revenue is recovered, rather than when it would have been recovered if the remade decision had always been in place.

Actual revenues under a WAPC are determined by the price in place and the level of out- or under-performance in each year.

As 2016-20 actual prices are above the remade decision level, our exposure to volume risk is initially higher.⁷ But this means 2020-25 prices must be lower and, in turn, our exposure to volume risk is also lower.⁸ So when looked at as a whole, there is a natural

⁴ Rule 92(2).

⁵ Rule 6.5.9 (3).

⁶ Assuming cross period revenue smoothing is enabled and applied.

⁷ And any out- or under-performance is at a higher price.

⁸ And any out- or under-performance is at a lower price.

balancing affect akin to what happens when revenues are smoothed within period in any AER access arrangement decision.

This remains consistent with the incentives within the regulatory contract in place with customers. This is the case even with actual revenues that diverge from those that might have occurred had the remade decision been in place from the start of the 2015 access arrangement period.

The idea of changing the approach to use actual volumes (rather than forecast volumes) to seek NPV neutrality was recently discussed with the AER. This would seek to unwind any out- or under-performance that is due to this movement in when JGN is exposed to the volume risk.⁹ This has a number of complexities that JGN has raised with the AER.¹⁰

If using actual volumes, this needs to be applied consistently to both the 2015-20 and 2020-25 access arrangement periods to ensure NPV neutrality

JGN considers that if actual volumes are used to calculate the over-recovery (the *remade 2015 access arrangement decision*) then actual volumes are also required to work out how much revenue needs to be returned (which includes the approach for the *adjustment amount*).

If a consistent approach is not applied JGN and consumers will not be left in a NPV neutral position on either an ex-ante basis or ex-post basis across the 2016-20 and 2020-25 access arrangement periods.

No practical need for a revenue recovery principle

JGN notes that the AER considers that the proposed rule, as currently drafted, 'may be interpreted to enable JGN to recover only the revenue to which it is entitled'¹¹, but the AER also considers that, for the avoidance of doubt, the final rule should include the revenue recovery principle.¹²

However, the AER approach to the *remade 2015 access arrangement decision*, which is outside the scope of this rule change, has no formal revenue recovery principle. If the AER can adopt a preferred approach for the remade decision that is in customers interests, without a revenue recovery principle, then there is no doubt that it could also apply it for the *adjustment amount* under the proposed rule.

For the reasons discussed, JGN does not consider there is a need for the revenue recovery principle. Including one would detract from the simplicity of the draft rule.

⁹ For example, out- or under-performance can arise due to: 1. actual volumes being different than forecast volumes (JGN retains); 2. actual price being higher than the remade decision price (JGN returns); and 3. a combination of the volume delta at the higher price. It is the third area that the AER is considering unwinding by using actual volumes.

¹⁰ JGN's position is that unwinding the volume delta at the higher price cannot be done in isolation given this is also a non-zero amount in the period that prices are lowered when returning revenue. That is, taking into account actual volumes requires:

- actual volumes to be known, which requires waiting until, at least, 2025 to resolve and a more complex true up process to be incorporated in the control mechanism;
- consideration of elasticity effects on demand (from the lower or higher prices); and
- how JGN might have set prices differently under a different pricing constraint.

¹¹ AER submission, p 4.

¹² AER submission, p 4.

If a revenue recovery principle is to be included, the drafting should be clearer

JGN considers there is a risk of unintended consequences of adding the revenue recovery principle with the drafting proposed. It introduces ambiguity as to how the proposed rule is to be interpreted and applied. For example, it is not clear:

- whether the principle is to be applied over the *2015 access arrangement period* only (in which case it would undermine the purpose of the proposed rule), or over multiple access arrangement periods;
- whether JGN must be able to recover the same amount of revenue as it would have recovered under the *remade 2015 access arrangement decision* under its form of control and hence on the basis of forecast volumes (as at the commencement of the period) or on the basis of actual and/or updated forecast volumes;
- how to give effect to the drafting that the remade decision control mechanism is assumed to apply in each historical year, as this is perhaps relevant to determining the amount of over-recovery in the 2015 access arrangement period, but not to determining an *adjustment amount*.

The second of these issues is particularly important, as it potentially impacts on the incentive properties and risk allocation under JGN's WAPC control mechanism – the regulatory contract in place.¹³

Should the AEMC be minded to include a revenue recovery principle, we would be happy to work with the AER and AEMC to draft an appropriate principle consistent with the WAPC form of control. We are available to achieve this within the current timeframes for assessing the rule change proposal.

End date for making an adjustment determination

In its submission the AER has also suggested extending the end-date for making an *adjustment determination* to some point in the next access arrangement period.¹⁴

To provide some additional time, JGN be open to include drafting which would allow an extension the end date in proposed clause (2)(b) by one month, until 1 April 2019.

However, JGN considers an extension of the end date beyond 1 April 2019 is unlikely to achieve the core purpose of the proposed rule change, which is to provide for smoothing of tariffs between the current and forthcoming access arrangement periods.

If an *adjustment determination* is made after 1 April 2019, there will not be sufficient time for any adjustments to be reflected in the annual tariff variation for the final year of the current access arrangement period (the 12-month period commencing on 1 July

¹³ We consider that this means that any assessment of revenue equivalence must be based on forecast volumes (as at the commencement of the 2015 access arrangement period). To the extent that the adjustment determination assessment were to be based on actual volumes (or an updated forecast), this would undermine the incentive properties and risk allocation under JGN's WAPC control mechanism.

¹⁴ AER submission, p 4.

2019).¹⁵ The annual tariff variation process for the final year of the current period represents the last opportunity to make an adjustment to recoverable revenue and reference tariffs for the current period.

JGN's proposed rule contemplates that smoothing will occur by way of shifting revenue recovery between the last year of the current access arrangement period and the next access arrangement period. The relatively simple design of JGN's proposed rule relies on the AER being able to remake the 2015 determination within the time allowed in the proposal.

If the AER is not able to finalise the *remade 2015 access arrangement decision and adjustment determination* by 1 March 2019 (or 1 April 2019 at the latest), a solution which goes beyond shifting of revenue recovery to achieve tariff smoothing would be required.

In this scenario, the solution would need to be more akin to the electricity participant derogations, which provide a form of 'true-up' in the next period, in the event that the 2015 electricity determinations are not remade ahead of the annual pricing proposal process for the last year of the current period. As the NSW / ACT electricity derogation process has showed, this is likely to result in a significantly more complex rule drafting exercise. It also potentially leads to greater complexity in the drafting of the enforceable undertaking that would be required effective from 1 July 2019, if this scenario is considered.

If you have any questions or would like to discuss any aspect of this supplementary submission with us, or in collaboration with the AER, please contact Chris Stewart on (02) 9867 7290 or at christopher.stewart@jemena.com.au.

Yours sincerely



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¹⁵ Under the JGN access arrangement, as approved by the AER on 3 June 2015, the annual tariff variation process formally commences on 15 March of the year in which variations are to take effect (cl 3.6). It is for this reason that JGN proposed an end date for making the adjustment determination of 1 March 2019, allowing JGN two weeks to reflect any adjustment in its annual pricing proposal for the 2019/2020 regulatory year. JGN expects that the tariff variation process for 2019-20 could be delayed by up to one month if needs be, meaning that the end date for making the adjustment determination could be extended by one month to 1 April 2019. However JGN considers that the end date could not be extended beyond 1 April 2019, as this would not allow sufficient time for completion of the tariff variation process by 1 July 2019.