



21 May 2014

Mr Matt Lady
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

AEMC reference: GRC0025

Dear Mr Lady

Thank you for the opportunity to comment on the Rule change proposal lodged by the Australian Energy Regulator (AER) in relation to setting the Opening Capital Base under the National Gas Rules (NGR).

APA Group (APA) makes the following comments on the proposed Rule change, and in response to the AEMC's Discussion Paper questions.

Responses to AEMC questions

Question 5.1.1: Do stakeholders agree that the issue identified by the AER in this rule change request needs to be addressed through a rule change and, if so, why? If not, please explain why the issue, as characterised by the AER, does not need to be addressed through a rule change or may be addressed in some other way.

APA does not agree that the AER has identified an issue with the NGR that requires Rule change. APA considers that:

- the regulator has sufficient powers under the gas access regime to ensure that estimates are accurate and meet the requirements of the rules;
- the regulator currently assesses actual, estimated and forecast capital expenditure under consistent rules and as part of the same process, ensuring that capital expenditure project plans are able to be assessed for prudence and efficiency, reducing the scope for inefficient estimates being approved; and
- the factors above are unique to the gas access regime and means that the formulation under the National Electricity Rules (NER), which the AER is proposing to emulate, is not appropriate or necessary under the NGR.

These factors mean that the rule change is unnecessary, as discussed below.

Regulatory assessment of estimates

Expenditure in the earlier access arrangement period, including estimated expenditure in the final year of the period, is subject to a number of requirements that ensure that the information is accurate and satisfies the NGR. APA considers that these requirements



mean that the regulator currently has sufficient powers and ability to assess the accuracy of estimates to ensure that they are not set inefficiently too high or too low.

Forecasts and estimates provided to the regulator must satisfy Rule 74 by being supported by evidence, arrived at on a reasonable basis, and represent the best forecast or estimate possible in the circumstances. In addition, all capital expenditure in the earlier access arrangement period is subject to review by the regulator under Rule 79. This review assesses whether that expenditure is prudent and efficient, and determines whether expenditure will be rolled into the capital base.

In addition, APA notes that the AER's practice in all recent reviews has been to require all actual, estimated and forecast information included in the access arrangement proposal to be accompanied by a statutory declaration signed by an officer of the service provider, declaring that the information provided is true and accurate and can be relied upon by the regulator. Further, as this information is provided to the regulator at the start of the access arrangement revision process, the regulator has adequate time to assess estimated values.

APA therefore does not consider that estimated values in the capital base suffer from less regulatory oversight, or are somehow less reliable or accurate, than forecast values for the next access arrangement period. These powers directly address the AER's concerns voiced in the Rule change proposal that there is an asymmetry of information between the service provider and the regulator that limits the ability of the regulator to assess estimates.¹

The AER is able to assess estimated values against the rules, and to determine that they are efficient. The AER's concerns that any inaccuracy leads to windfall gains or losses unrelated to efficiency are therefore unfounded as they do not adequately take account of the regulator's existing powers to address these matters through the approval of estimates included in the capital base.

Regulator currently assesses efficiency and prudence of capital expenditure over time and between periods

As noted above, the NGR requires the regulator to assess actual, estimated and forecast expenditure against rule 79 before it is rolled into the capital base. This provides the regulator with the scope to assess full project plans over time, without the timing of the access arrangement period impacting the degree of scrutiny.

Under this approach, the AER can assess estimated expenditure in the final year of the earlier access arrangement period as part of a total project plan. This significantly reduces the scope for inefficient estimates (either too high or too low) being accepted as these are likely to affect the regulator's assessment of the prudence and efficiency of the capital program as a whole.

¹ Australian Energy Regulator 2013, Rule Change proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, p 10



Differences between electricity and gas access regimes

The ability of the regulator to assess the prudence and efficiency of incurred capital expenditure is unique to the gas access regime – there are no similar powers under the electricity access regime.

Rule 77(2)(b) of the NGR provides for only conforming capital expenditure² made, or to be made, in the earlier access arrangement period, to be rolled into the capital base. Apart from a recently introduced and very limited power for *ex post* review of expenditure where expenditure exceeds forecasts (and a limited number of other circumstances), estimated values receive no regulatory assessment for prudence or efficiency under the NER before being rolled into the capital base.

APA considers that the ability of the regulator to assess whether capital expenditure in the earlier access arrangement period is conforming capital expenditure makes it unnecessary to also adjust for any benefits or penalties arising from differences between estimated and actual expenditure, as the regulator has had opportunity to assess estimated values for efficiency and prudence as part of a complete capital plan prior to their inclusion in the capital base.

Question 5.3.1: In what way do you consider the proposed rule change may or may not affect efficiency in providing gas pipeline services and the long term interests of consumers?

APA considers that the AER's proposed rule change potentially means that a service provider is not given an opportunity to recover its efficient costs in providing reference services.

There are practical reasons why actual expenditure may deviate from estimates. The most likely reason relates to a project delay, such that expenditure instead falls in the forecast period. Delays may be experienced due to circumstances that are outside the control of the service provider such as weather, the timing of land and other environmental approvals, or delivery lead times. In cases where expenditure is ultimately incurred by the service provider (sometimes very shortly after the estimated period) the delay will not lead to windfall gains or losses of the scale suggested by the AER in the Rule change proposal.

The rule change proposal refers at length to a recent decision by the Australian Competition Tribunal in respect of APA GasNet, which considered whether the AER had power under the NGR to adjust the capital base to take account of benefits or penalties associated with differences between estimated and actual expenditure under the NGR.³ In particular, the AER refers to this process as highlighting the potential scope of adjustments that could be made under such a power.⁴

The AER does not, however, discuss a key part of the Australian Competition Tribunal case relevant to this matter. In the case in question, APA GasNet completed the majority of projects estimated to occur in the final year of the earlier access arrangement period in

² That is expenditure that has been assessed to satisfy Rule 79 of the National Gas Rules

³ Application by APA GasNet (Operations) Pty Ltd (No 2) [2013] ACompT8, 18 September 2013

⁴ Australian Energy Regulator 2013, Rule Change proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, pp 10-11



the immediately following period.⁵ APA GasNet therefore did not receive a windfall gain of the scale suggested by differences between estimated and actual expenditure in the final year of the earlier access arrangement period, as it incurred the expenditure shortly afterwards.

In fact, the AER's approach, had it been accepted by the Tribunal, would have meant that APA GasNet did not receive a return on expenditure assessed by the regulator as prudent and efficient under Rule 79, until the access arrangement period that follows (5 years later), because of a delay in expenditure that meant expenditure was incurred in the forecast rather than estimated period.

Consideration of this case, and the scope for similar circumstances to be faced by other service providers, uncovers important issues with the AER's rule change proposal, in particular its potential to lead to outcomes that are not in the long term interests of consumers.

The AER states that its proposed amendment is intended to "place the regulated firm in exactly the same position as it would have been had we been able from the outset to use actual capital expenditure for the last year of period *t*."⁶

APA contends that the AER's proposal does not and cannot do this as it cannot address the uncertainty faced by the service provider and the AER that exists at the time of proposing and approving both estimated and forecast expenditure, in particular, the eventual split of expenditure between access arrangement periods. As capital expenditure estimated to occur in the earlier access arrangement period is not also forecast to occur in the forecast period, the AER's proposed adjustment would mean that any delay in timing of a project such that expenditure ultimately occurs in the forecast period would see the service provider receive no return on that expenditure until the start of the access arrangement that follows (5 years later).

This demonstrates the risk inherent in the AER proposed approach, as it does not adequately take account of the interrelated nature of estimated and forecast capital, particularly where it relates to projects that span two regulatory periods.

APA submits that the circumstance of unforeseen delays in expenditure, which it believes is the most likely circumstance to give rise to differences between estimates and actual expenditure given the regulator's ability assess estimates for prudence and efficiency, would have adverse impacts on the service provider, and lead to inefficient tariffs that are not in the long term interests of consumers. The Rule change proposal creates a real risk that the service provider is not provided with a reasonable opportunity to recover its efficient costs incurred in providing reference services, as required under the revenue and pricing provisions of the National Gas Law.⁷

⁵ Application by APA GasNet (Operations) Pty Ltd (No 2) [2013] ACompT8, 18 September 2013, at [144]-[147]

⁶ Australian Energy Regulator 2013, Cover letter, Rule Change proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, p 1

⁷ National Gas Law, section 24(2)



Question 5.3.3: How would the rule as proposed impact upon service provider efficiency incentives that underpin the regulatory regime?

The AER has characterised the current construction of Rule 77(2)(a) of the NGR as providing incentives for service providers to inflate estimates in the final year of the earlier access arrangement period, leading to the potential for windfall gains or losses by service providers or customers⁸ that are unrelated to efficiency⁹. APA considers that the AER's rule change proposal overstates this risk.

APA considers that the current construction of the NGR provides service providers with an incentive to beat forecast and estimated values. This means that the service provider will always have an incentive to reduce capital expenditure and make efficient investment decisions. This incentive would apply in respect of both forecast capital expenditure values, and estimated capital expenditure values, creating consistent (and perhaps even stronger) incentives for efficient investment between regulatory periods.

APA considers that the regulator's powers to review estimates against both rules 74 and 79 mean that the risk of inflated estimates is overstated, and able to be addressed under the regulatory regime using existing powers.

Question 5.2.2: Do you consider the wording of the proposed rule is sufficiently clear and accurately captures the intended adjustment to the accumulated return on capital in the circumstances noted?

APA agrees with the observation in the AEMC's discussion paper on the Rule change proposal that the formulation of the AER's proposed revisions is very broad, and adjustments are not necessarily confined, as the AER appears to intend, to revenue associated with return on capital in respect of estimates. APA considers that the proposed rule, if made, should be revised to make clear the scope of the proposed adjustment, and what is meant by benefits and penalties.

Further comments on rule change proposal

The AER cites alignment with the electricity gas regime as a supporting factor for the Rule change proposal.

As noted earlier in this submission, there are a number of material differences between the electricity and gas access regimes that lead to materially different regulatory processes and oversight of matters such as capital expenditure. These differences extend beyond the treatment of estimated values under the capital base, and include matters such as redundant capital, speculative capital, prudent discounts, tariffs and cost allocation, and terms and condition of access.

Singling out one area of difference and referring to the desire of policy makers to make the regime consistent ignores the myriad of clear and purposeful differences between the regimes. This intent is shown in the second reading speech for the National Gas (South

⁸ Australian Energy Regulator 2013, Rule Change proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, p 4

⁹ Australian Energy Regulator 2013, Rule Change proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, p 8



Australia) Bill, where the Minister expressly stated under the heading "Access Arrangements" (9 April 2008, page 2884):

The intention has been for the Rules concerning access arrangements to **replicate the regulatory model operating under the Gas Code** while implementing the Ministerial Council on Energy's response to both the Productivity Commission's Review of the Gas Access Regime and the Expert Panel on Energy Access Pricing. **In a small number of areas, such as pricing principles for distribution networks, the gas regime has been aligned to the regime in the National Electricity Rules to promote greater consistency in regulation.** [Emphasis added]

This shows that consistency was not intended to stretch to all matters under the regimes, but instead to ensure consistent frameworks for decision making and development of the different regimes. APA therefore does not consider that consistency between the electricity and gas access regimes is a relevant consideration for this rule change proposal.

APA would be pleased to further assist the AEMC in its consideration of this Rule change proposal. If you would like any further information, please call Alexandra Curran on 02 9275 0020.

Yours sincerely

A handwritten signature in black ink, appearing to read "P. Bolding", with a long, sweeping horizontal stroke at the end.

Peter Bolding
General Manager Regulatory & Strategy