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Contact: Tyson Self

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
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Dear Mr Pierce

Submission on Draft Rule Determination: National Gas Amendment (Setting the Opening Capital Base) Rule 2014

Thank you for providing the opportunity for the Economic Regulation Authority (**ERA**) to make a submission on the Australian Energy Market Commission's (**AEMC**) Draft Rule Determination to the rule change proposal submitted by the Australian Energy Regulator (**AER**) in relation to rule 77(2)(a) of the National Gas Rules (**NGR**).

The ERA notes that it has a strong interest in the outcomes relating to this Draft Rule Determination, as it would affect the way in which the ERA determines the opening capital base at the start of an access arrangement period for covered gas transmission pipelines and distribution networks in Western Australia under the NGR.

The ERA has considered the AEMC's Draft Rule Determination and the public submissions received by the AEMC in response to the Draft Rule Determination.¹ The ERA provides the following comments.

The issue to be addressed

The service provider is generally required to submit an access arrangement in the year prior to its intended start date.² As a result, the service provider estimates the capital expenditure required for the final year of the access arrangement, period n , which is then used to determine the opening capital base for the subsequent access arrangement period, $n+1$. The relevant regulator would assess the estimate provided by the service provider in accordance with rules 74 and 79 to determine the estimate to be used in the opening capital base for the calculation of reference tariffs in the period $n+1$. This would generally occur only months before period $n+1$ was due to commence.

The actual capital expenditure during the final year of period n may differ from the estimate approved by the relevant regulator for the purpose of setting the opening capital base. The service provider will either gain or lose depending on whether the estimate was above or below the actual. Any gains or losses primarily arise through the calculation of the return on asset and the depreciation components of the building block revenue calculation.

If the regulator was unable to correct this estimation error, the service provider would then either benefit or be penalised over the remaining life of the asset. The current NGR does allow

¹ AEMC, Setting the Opening Capital Base, Draft Rule Determination, 10 July 2014.

² *National Gas Rules*, Version 21, rule 50.

the regulator to correct the opening capital base for the following access arrangement period, $n+2$.³ The adjustment under rule 77(2)(a) currently only allows for an adjustment between the estimated and actual capital expenditure. Adjustments for flow on effects to depreciation and the return on asset are not included. As such, the service provider would either gain or lose during period $n+1$ without an adjustment for the consequences of the estimation error. The ERA notes that it is on this basis that the AER submitted its proposal to have rule 77(2)(a) amended to allow for an adjustment to “remove any benefit or penalty associated with any difference between the estimated and actual capital expenditure”.⁴

ERA's submission on AEMC Consultation Paper

The ERA previously made a submission in response to the AEMC's Consultation Paper, stating its support of the AER's rationale for requesting a rule change and also providing an alternative approach to adjusting for the estimation error associated with the final year capital expenditure.⁵

In its submission, the ERA noted the conflicting decisions from the Australian Competition Tribunal (**Tribunal**) with respect to APA GasNet and Jemena Gas Networks.⁶ The ERA also noted that as a result of the APA GasNet decision, there could now exist an incentive for service providers when submitting revisions to an access arrangement to overestimate capital expenditure forecasts in the final year of the current access arrangement to pursue the short term goal of revenue maximisation rather than seeking efficiency gains. This would result in a windfall gain to service providers for any overestimate. As such, the ERA agrees with the AER's view that an amendment to the NGR is likely to better contribute to the achievement of the National Gas Objective (**NGO**), especially with respect to promoting efficient investment.⁷

Whilst the ERA agrees that an amendment is necessary in order to contribute to the achievement of the NGO, it also considers that the NGR should provide for alternative methods to adjust for the estimation error. The ERA understands the AER's method to be a pure capital based adjustment, which for an underestimate of capital expenditure in period n , would in effect capitalise the return on capital that the service provider was owed over the previous access arrangement period, $n+1$. However, technically, the return on capital would have been treated as a cash flow item had the estimates been correct in the first instance. If the adjustment is capitalised as required by the AER's approach, it would result in the service provider and users facing an adjustment for the return on capital over the life of the relevant assets in the regulatory asset base. This represents a slow and drawn out adjustment for users and service providers.

As stated in the previous submission, the ERA's preferred approach to the adjustment for the return on capital associated with the estimation error in period n would be a one-off cash flow adjustment to the first year of the $n+2$ access arrangement. Alternatively, the adjustment could be applied in a present value neutral way across all years in the $n+2$ access arrangement period. The ERA considers that this approach would allow the regulator and service providers to address the required adjustment as soon as possible, thereby providing clarity and certainty to all parties, including users. Any resulting changes in prices from the adjustment would also be confined to the $n+2$ access arrangement period only. The benefit of this approach would

³ *National Gas Rules*, Version 21, rule 77(2)(a).

⁴ AEMC, *Setting the Opening Capital Base*, Draft Rule Determination, 10 July 2014.

⁵ ERA, *Submission on Consultation Paper: National Gas Amendment (Setting the Opening Capital Base) Rule 2014*, 30 May 2014.

⁶ Australian Competition Tribunal, *Application by APA GasNet (Operations) Pty Ltd (No 2) [2013] ACompT8ACT*. Australian Competition Tribunal, *Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT6*.

⁷ *National Gas Access (WA) Act 2009*, section 23.

be that prices revert to efficient levels faster, providing the right economic signals to customers consistent with the NGO.

The ERA acknowledged in its submission that its approach could potentially cause prices to vary more in the short term than compared with the AER's approach because of the shorter adjustment period. However, provided that service providers comply with rule 74 in forming its estimates, the ERA believes that the likelihood of a large price shock should be minimised.⁸

Response to the AEMC Draft Rule Determination

With respect to the scope of adjustment and wording of the draft rule, the ERA supports the AEMC's decision in drafting the rule as proposed by the AER. The ERA notes the AEMC's view "that the wording of the proposed rule and the relevant historical practice provide sufficient clarity and certainty to affected parties as to the intended operation and application of the proposed rule".⁹ The ERA agrees with the AEMC's view that the proposed rule "provides a level of discretion to the economic regulator to interpret and apply the relevant adjustment that is appropriate to the circumstances".¹⁰ The ERA acknowledges that this wording will provide the relevant regulator with some level of flexibility.

The ERA supports the AER's intent and rationale as demonstrated in its proposal. Accordingly, the ERA considers that the AEMC's Draft Rule Determination will help in removing the regulatory uncertainty and inconsistency that exists at present as a result of the conflicting Tribunal decisions. The ERA is also hopeful that this rule change determination will help contribute to the achievement of the NGO.

The ERA's preferred adjustment elaborated

Despite its general agreement on the intent and rationale of the adjustment, the ERA is concerned that its proposed approach was not adopted by the AEMC as an alternative rule for the NGR. The ERA considers that the final rule determination should provide the relevant regulator flexibility as to which approach it applies to adjust for the estimation error, so long as it meets the NGO. The ERA does not believe that its proposed alternative approach is mutually exclusive to the AER's proposed rule change, but would prefer to have the flexibility to apply the adjustment through cash flow adjustments to the revenue building blocks, if it so chooses. As no access arrangements approved by the ERA under the NGR have applied rule 77(2)(a), the ERA believes that the "new processes" would not unfairly disadvantage the three service providers operating in Western Australia.¹¹

Given the comments made by the AEMC in the Draft Rule Determination, the ERA considers that it would be helpful to all parties if it further elaborated on its proposed alternative to the AER's capital based adjustment.

As part of the initial assessment of the AER's proposal and the AEMC's Consultation paper, the ERA undertook an extensive modelling exercise to demonstrate the impacts on the revenue building blocks and the regulatory asset base.¹² Through the modelling exercise, the ERA found that it was not possible to correctly adjust for the estimation error for final year capital expenditure in period *n* by simply removing the estimation error in full from the

⁸ *National Gas Rules*, Version 21, rule 74.

⁹ *Ibid.*, p. 16

¹⁰ *Ibid.*

¹¹ AEMC, *Setting the Opening Capital Base, Draft Rule Determination*, 10 July 2014, p. 18.

¹² AEMC, *Setting the Opening Capital Base, Consultation Paper*, 17 April 2014. AER, *Rule Change Proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules*, 11 November 2013.

regulatory asset base in period n+2. This is because depreciation would occur in period n+1 for the overestimate in capital expenditure, resulting in extra cash flows for the service provider through the revenue building blocks.¹³ Conversely, an underestimate in capital expenditure for period n would result in reduced cash flows during period n+1 for the service provider. Both scenarios would require an adjustment for the cash flows associated with depreciation, in addition to the original issue of the return on capital associated with the estimation error. The ERA notes that the AER's original proposal omitted depreciation as an input from its example to isolate the effect of the proposed rule change, and hence is not present throughout the discussion.¹⁴

The ERA's approach adjusts for the full amount of the estimation error, which occurred in period n, from the opening regulatory asset base in period n+2.¹⁵ As a result, the revenue requirement from period n+2 will ensure tariffs are calculated based on actual capital expenditure in period n. However, this adjustment will only impact on the building block calculation for the period n+2, as the tariffs are not adjusted during period n+1 for the estimation error. As a result, the cash flow adjustment mentioned above would only correct for the under or over recovered revenue amount earned during period n+1, due to the estimation error that occurred in the last year of period n.

Implementation of the ERA preferred adjustment

As stated in its previous submission, the ERA's alternative approach could be implemented through an amendment to rule 76 to allow for the cash flow adjustment to be applied as an extra component, (f), if applicable, and would be confined to only the n+2 access arrangement. The cash flow adjustments for the overestimate or underestimate would be subtracted or added back respectively to the total revenue requirement for the n+2 access arrangement period.

The ERA notes the AEMC's concerns with respect to "price variations where material differences between estimated and actual capital expenditure do occur"¹⁶. The ERA has undertaken modelling of its approach which shows that the difference between estimated and actual capital expenditure would have to be considerably large in order for there to be a material price variation. If such a material difference were to occur, the actual capital expenditure submitted would still have to be compliant with rule 79.

The ERA acknowledges that at the time of submitting the initial proposal for the n+1 access arrangement, there may be a degree of uncertainty surrounding the amount of capital expenditure for final year capital expenditure for period n. However, after the publication of the draft decision by the relevant regulator, the service providers are able to submit revised proposals with updated estimates for final year capital expenditure. The AER stated that "such an estimate will be based on actuals (albeit unaudited) for part of the final year".¹⁷ The ERA considers that as the amount of time where estimates are relied upon is reduced, it is less likely that a material difference will occur between estimated and actual capital expenditure. Accordingly, this would reduce the possibility of material price variations.

Separate to the NGR, the ERA must also take into consideration the *National Gas Access (WA) (Local Provisions) Regulations 2009*. Under these regulations, the ERA must consider

¹³ *National Gas Rules*, Version 21, rule 76(b).

¹⁴ AER, Rule Change Proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, Appendix C, 11 November 2013.

¹⁵ In accordance with rule 77(2)(a).

¹⁶ AEMC, Setting the Opening Capital Base, Draft Rule Determination, 10 July 2014, p. 18.

¹⁷ AER, Rule Change Proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules, p. 2.

the impact on small use customers and retailers when making an access arrangement for a distribution pipeline.

Response to other public submissions

The ERA notes the support provided by the Major Energy Users Inc. (MEU) in its submission to the AEMC. The ERA notes the MEU's concern that the issue of price stability appears to have a higher standing in the AEMC assessment than recovering costs to the consumers as quickly as possible. As mentioned in its earlier submission, the ERA considers that the impact to prices can be minimised if estimates are formed on a reasonable basis.¹⁸ The ERA also notes that any capital expenditure amounts must still pass the conforming capital expenditure criteria as specified in rule 79. Accordingly, the ERA supports the MEU in its recommendation to the AEMC to seek "greater clarification from consumer[s] as to whether lower costs now are less preferred than in the future in order to provide price stability".

The ERA notes the timing concerns expressed by DBP. The ERA agrees with DBP's view that "the longer one waits for the true-up, the greater are the amounts of money involved, and thus the greater risk that tariffs applying in the interim are inefficient as they are either set too high or too low".¹⁹ The ERA considers that its approach helps to alleviate this delay by confining the adjustment to one access arrangement period, rather than the life of the asset. With respect to limiting the scope of the adjustment, the ERA does not agree with DBP's assessment. The ERA notes DBP's concerns that in future periods, the regulator may use future information to "undo the consequences of past forecasting errors (not related to estimates)".²⁰ The ERA considers that the AER's rule proposal and its own proposed alternative approach will only make adjustments arising from the capital expenditure estimation errors. The ERA does not believe that the current scope needs to be tightened as this provides sufficient clarity and certainty, whilst also allowing the relevant regulator to make the appropriate adjustments.

The ERA notes DBP's proposed tariff adjustment alternative approach and considers that it could work in theory, but would result in some implementation issues. The ERA notes that DBP's approach would apply through a tariff variation mechanism as soon as practicable in the n+1 access arrangement period (if the estimate occurred in period n). The ERA considers that a revenue based adjustment is the first best approach to expedite the adjustment. However, the approach proposed by DBP would result in a subsequent review of capital expenditure one year or two years immediately following a full access arrangement review. The conforming capital expenditure review to be undertaken by the regulator would have to ensure that the capital expenditure amounts are compliant with rule 79, and could also require the appointment of an external technical advisor. The ERA notes that tariff variations typically occur in a shorter timeframe, whereas the review of capital expenditure would require a longer timeframe. The ERA considers that DBP's approach, would increase the regulatory burden for both the service provider and the relevant regulator. The ERA also notes DBP's concerns with respect to the potential for double counting the adjustment required.²¹ As previously discussed, the ERA considers that its approach would not double count the adjustment required.

The ERA notes the APA Group's views with respect to regulatory certainty and transparency. The ERA considers that a rule change is necessary in order to remove any uncertainty as a

¹⁸ *National Gas Rules*, Version 21, rule 74.

¹⁹ DBP, *Submission to GRC0025: National Gas Amendment (Setting the Opening Capital Base) Rule 2014*, 21 August 2014, p. 3.

²⁰ *Ibid.*

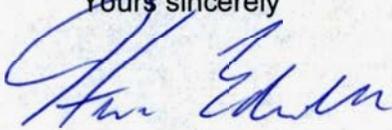
²¹ *Ibid.*

result of the conflicting Tribunal decisions. However, the ERA does not agree with the APA Group's view that "the most recent Tribunal decision is correct and reflects the intent of the Rules".²² The ERA supports the intent of the AER's rule change and rationale. With respect to the APA Group's views on the scope of the adjustment, the ERA does not consider it necessary to amend the wording of the draft rule as it allows the relevant regulator to make adjustments appropriate to the circumstance. The ERA considers that flexibility is required rather than a tightly prescribed rule as suggested by the APA Group.

In summary, the ERA supports the AEMC's arguments in relation to the scope of the adjustment, but also encourages it to consider the ERA's preferred approach.

The ERA would be pleased to further assist the AEMC in its consideration of the rule change proposal and the views the ERA has expressed in this submission. Please contact Robert Pullella, Executive Director Access on 08 6557 7900 if you would like more information.

Yours sincerely



STEVE EDWELL
MEMBER

12/10/2014.

²² APA Group, *Submission to GRC0025 Draft Rule Determination, 21 August 2014*, p. 2.