

## **Submission to the AEMC:**

### **Review into the scope of economic regulation applied to covered pipelines**



**25 August 2017**



Ms Sherine Al Shallah  
Project Leader  
Australian Energy Market Commission

Submitted online to AEMC's website – [www.aemc.gov.au](http://www.aemc.gov.au).

Dear Ms Sherine,

## Review into the scope of the economic regulation applied to covered pipelines

The parties to this submission called "Consortium of Market Participants" welcome the opportunity to comment on the Australian Energy Market Commission's (AEMC) *Review into the Scope of Economic Regulation Applied to Covered Pipelines*.

This submission focuses specifically on the matter of conforming capital expenditure for regulated pipelines. As noted in the AEMC's issues paper, in order for capital works to be approved they must conform with rule 79(1)(a) which states that:

"the capital expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services".

On the surface, this requirement makes sense. That only such capital works as considered prudent by the Australian Energy Regulator (AER) should be approved (subject to meeting rule 79(2)(a-d)) and, subsequently, it would not be prudent for a regulated entity to be forced into undertaking approved capital works – where such works are no longer required due to changing market conditions or other relevant circumstances. The central tenet of this rule is that it aims to ensure that end use customers do not pay more for capital infrastructure than would occur in a competitive market – thereby delivering the 'lowest sustainable cost' of service provision.

The complication that this rule creates is that it leaves open the real possibility that capital works, once approved by the AER, are either not completed, or only partially completed, by the regulated entity – as the entity no longer considers them to be prudent. This has specific ramifications for works that have been assessed on the basis of ensuring the safety and integrity of services.

An additional problem that this rule creates is that it may diminish allocative efficiency. This is because the regulatory regime allows the regulated entity to recover the costs of the approved capital works, via pipeline tariffs, from users – without completing the works. Furthermore, the regulated entity is provided the opportunity to request that the AER incorporate the approved capital works into its forward capital works budget – to be spent on other works within its capital work program. It is important to note that if the AER does not approve the transfer, the regulated entity is required to surrender the capital recovered but is able to retain the interest earned on the funds in the meantime.

Ultimately, the provisions of rule 79(1)(a) may mean that system security and integrity may be diminished as the regulated entity can assess whether the works are prudent, whilst end use customer bills still increase, even though capital works may not have not been completed – diminishing efficiency.

A pertinent example of this issue, is the ongoing works on the Brooklyn Compressor Station (BCS). Upgrade works were put forward by APA (and first approved by the Australian Competition and Consumer Commission) in 2007 and most recently considered – and given draft approval – by the AER in its draft decision on the APA Victorian Transmission System – Access Arrangement 2018-22. As part of its draft decision the AER approved the following:

#### **Brooklyn Compressor Station Upgrade**

APA has proposed \$7.1 million (\$2017) to upgrade several components of the BCS. This includes upgrades to the safety system, process control system, unit control system, ventilation system, fuel gas system and exhaust stack to maintain the life of the BCS and the units past 2022.

Australian Standard 3814-2015 requires that where an appliance is modified or relocated it must be upgraded to meet the Standard current at the time of modification or relocation.

APA's proposal will extend the life of the BCS and enable it to meet the requirements of AS 3814-2015. For these reasons, it appears prudent, in accordance with good industry practice and achieves the lowest sustainable cost of providing services. It is also justified on the ground of maintaining the integrity of services.

Our position in this draft decision is that the proposed \$7.1 million (\$2017) to upgrade the BCS is conforming capex.

Approved capital works at Brooklyn had previously been approved to the value of \$58.6 million. However, the sum approved was not ultimately spent and now APA has sought additional approval to upgrade the BCS to complete safety works. It is not clear:

- Why the initial approved capital works were not completed – elements of which were specifically targeted at improving security and integrity of the facility;
- How revenues recovered for the BCS upgrade were subsequently allocated;
- Why APA need to approach the AER for approval of additional works at the Brooklyn site – given the previously approved program of works to the sum of \$58.6 million;
- Whether it is efficient for the regulator to be tasked with assessing the same project on numerous occasions.

The parties to this submission suggest that the incentives created by rule 79(1)(a) – and highlighted in the Brooklyn Compression Station Upgrade example above – should be investigated further by the AEMC. Specifically, the AEMC should give consideration as to whether the issues created by this rule could be mitigated by the following:

- Compelling a regulated entity to pursue the completion of capital works where such works have been approved by the regulator on the basis of ensuring the safety and integrity of services;
- Increasing transparency as to the financial recovery for approved works;
- Tariffs to recover the cost of the capital works should only be levied once the capital works program have been completed;
- Where a regulated entity has not completed capital works that have been approved by the regulator, the AER can recover all of the administrative costs associated with completing the assessment;
- The regulator to complete an ex-post assessment of the approved capital works and if the funds weren't spent then the regulated entities capital pool would be reduced by an equal amount – with pipeline tariffs to also be commensurately reduced; and



**Submission to AEMC**

Ultimately, any framework aimed at delivering an efficient and effective regulatory regime for covered pipelines, has to be flexible enough so that if circumstances change during the 5 year regulatory period then the capital works program can change, but is also stringent enough such that when capital works are actually required they are delivered.

Please do not hesitate to contact me if you require further information in relation to this submission.

Yours sincerely,

Kon Wong  
General Manager Commercial  
On behalf of the Consortium of Market Participants

