

Australian Energy Market Commission

DRAFT RULE DETERMINATION

National Gas Amendment (Setting the Opening Capital Base) Rule 2014

Rule Proponent

Australian Energy Regulator

10 July 2014

**RULE
CHANGE**

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About the AEMC

The AEMC reports to the Council of Australian Governments (COAG) through the COAG Energy Council. We have two functions. We make and amend the national electricity, gas and energy retail rules and conduct independent reviews for the COAG Energy Council.

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Summary

The Commission has made a draft rule to amend how the economic regulator calculates the value of a regulated gas pipeline. Prior to the start of a new access arrangement period, the value of the opening capital base for the regulated pipeline must be set. The amending draft rule requires this calculation to include the removal of any benefit or penalty arising out of the difference between estimated and actual capital expenditure in the final year of a prior access arrangement period.

The draft rule is expected to prevent service providers from experiencing benefits or losses arising out of a difference between estimated and actual capital expenditure used to set the opening capital base. This in turn should result in reference tariffs for the regulated pipeline reflecting efficient actual capital expenditure.

The draft rule is made in response to the Australian Energy Regulator's (AER) rule change request concerning the methodology used to set the opening capital base in respect of certain gas pipelines and access arrangements. Part of the economic regulation of certain pipelines includes the assessment and approval of access arrangements. The draft rule reflects the AER's proposed rule, subject to a minor typographical correction, and applies to pipelines regulated by the AER and, in Western Australia, the Economic Regulation Authority.

Reasons for the Commission's decision

The Commission considers that the draft rule is likely to contribute to the achievement of the national gas objective (NGO) by preserving the incentive framework of the regulatory regime that rewards service providers when they spend less capital expenditure than forecast.

Under the draft rule, reference tariffs are more likely to reflect efficient utilisation of, and investment in, pipeline services because they would be less likely to be influenced by gains or losses unrelated to the efficiency of the service provider. This outcome accords with and aims to further the NGO.

Conversely, maintaining the current provisions could encourage an unintended incentive for service providers to pursue inefficient revenue maximisation. This would not be in the long term interests of consumers.

The Commission has also considered the vital roles that regulatory certainty and transparency in the methodologies used by the economic regulators play in contributing to a stable investment environment and the promotion of the NGO. It notes that the ability of the AER to make the relevant adjustment has been the subject of dispute between the AER and certain service providers.

The Commission considers the draft rule will reinforce both regulatory certainty and transparency and thereby further promote the NGO.

Invitation for submissions

The Commission welcomes submissions on this draft determination by 21 August 2014.

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1 AER's rule change request

1.1 The rule change request

On 11 November 2013, the Australian Energy Regulator (AER, the proponent) made a request to the Australian Energy Market Commission (AEMC) to make a rule regarding the methodology and requirements of setting the opening capital base in certain access arrangements for natural gas pipelines (the rule change request).

More specifically, this rule change request concerns the methods utilised by the AER and the Economic Regulation Authority (ERA) to set the opening capital base in respect of certain access arrangements under rule 77(2)(a) of the NGR.

The rule change request proposed to modify the NGR to require the economic regulator to adjust the opening capital base to remove any benefit or penalty arising out of any difference between estimated and actual capital expenditure in the final year of an earlier access arrangement period.

Appendix B provides more detail about the relevant regulatory background, including the requirements to set an opening capital base.

1.2 Rationale for the rule change request

As set out in the rule change request, the AER sought to modify the approach the economic regulators use to set the opening capital base associated with certain access arrangements by requiring the removal of any benefit or penalty associated with any difference between estimated and actual capital expenditure in the preceding access arrangement period.

The AER submitted that the proposed change is required to prevent pipeline service providers from experiencing benefits or losses due to a difference between the estimated and actual final year capital expenditure used to set the pipeliner's opening capital base.

Gains or losses not related to the efficiency of service providers, the AER submitted in its rule change request, conflict with the NGR because they can adversely affect pipeline investment and usage incentives, and lead to price distortions.¹ The AER argued that without the ability to make an adjustment to remove any benefit or penalty associated with the difference between estimated and actual capital expenditure of a preceding access arrangement period, in cases where the actual capital expenditure is less than the estimated capital expenditure, service providers will retain a benefit of additional revenue that will be funded by increased reference tariffs during the course of the relevant access arrangement period.²

1 AER rule change proposal, 11 November 2013, p1.

2 *ibid*, p9.

1.3 Solution proposed in the rule change request

The AER has proposed to resolve the issue discussed above by amending rule 77(2)(a) to require the economic regulator to remove any benefit or penalty associated with the difference between estimated and actual capital expenditure included in the opening capital base of a relevant access arrangement.

To do this, the AER has proposed the following text be added to the end of rule 77(2)(a) noted above:

“This adjustment must also remove any benefit or penalty associated with any difference between the estimate and actual capital expenditure;”

The Commission notes the above quote appears inadvertently to omit the letter "d" in the word "estimate". Based on statements in the rule change request, and the proponent's intention to mirror the equivalent provision of the NER, the Commission considers the text below accurately reflects the intention of the proposed rule:

“This adjustment must also remove any benefit or penalty associated with any difference between the estimated and actual capital expenditure;”

1.4 Current arrangements

Setting the opening capital base

Under the NGR, the total revenue for each year of an access arrangement period is derived using the building block approach, which includes the projected capital base.³ The opening capital base makes up part of the projected capital base. Total revenue, in turn, is used to calculate reference tariffs.

The NGR provides a methodology the economic regulator must use to set the opening capital base for a subsequent access arrangement period where an access arrangement period follows immediately on the conclusion of a preceding access arrangement period.⁴

³ The building block approach combines: a return on the projected capital base for the year; depreciation on the projected capital base for the year; the estimated cost of corporate income tax for the year; increments or decrements for the year resulting from the operation of an incentive mechanism to encourage gains in efficiency; and a forecast of operating expenditure for the year.

⁴ The NGR also provide other methods to calculate the opening capital base, for example, when a pipeline first becomes a covered pipeline or if a period intervenes between access arrangement periods during which the pipeline is not subject to a full access arrangement. However, this rule change request does not affect these methods.

Relevantly, rule 77(2)(a) provides:

“If an access arrangement period follows immediately on the conclusion of a preceding access arrangement period, the opening capital base for the later access arrangement period is to be: (a) The opening capital base as at the commencement of the earlier access arrangement period (adjusted for any difference between estimated and actual capital expenditure included in that opening capital base).”

It is this part of setting the opening capital base that forms the subject of the rule change request.

A more detailed examination of the methodology the economic regulator currently must use when setting the opening capital base is considered at Appendix B.

1.5 Background

The impetus for this rule change request arises out of a recent decision of the Australian Competition Tribunal (Tribunal), the APA GasNet decision.⁵ In this decision, the Tribunal held that the wording of rule 77(2)(a) does not empower the AER to adjust the opening capital base with respect to the revenue associated with the return on capital arising out of the difference between estimated and actual capital expenditure in the final year of a relevant access arrangement period.⁶

In its rule change request, the AER also expressed concern that the current arrangements for setting the opening capital base, following the APA GasNet decision, may provide a financial incentive for service providers to over-estimate total final year capital expenditure and to defer efficient expenditure.⁷ The proposed rule, the AER asserts, will prevent service provider incentives from being skewed towards overestimating or underestimating in the final year of an access arrangement period.

Rather, service providers would be focused equally, across the access arrangement period, on the efficiency incentive of spending less than forecast capital expenditure. This, the AER submits, will promote the long-term interests of consumers of natural gas, particularly with respect to price.

In 2011, the Tribunal also considered the ability of the AER to make an adjustment to the return on capital component of the opening capital base to account for any difference between estimated and actual capital expenditure under rule 77(2)(a).⁸ In this decision, the Jemena decision, the Tribunal held that the policymakers who drafted the NGR intended for there to be consistency between electricity and gas regulation

⁵ Application by APA GasNet (Operations) Pty Ltd (No 2) [2013] A CompT8 (APA GasNet decision).

⁶ *ibid*, [141].

⁷ AER rule change proposal, 11 November 2013, p5.

⁸ Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] A CompT6 (Jemena decision).

and did not intend that gas pipelines should be allowed to keep the return on capital associated with an over-estimation while electricity networks would not.⁹

1.6 Commencement of the rule-making process

On 17 April 2014, the Commission published a notice advising of its intention to commence the rule making process and the first round of consultation in respect of the rule change request. A consultation paper prepared by AEMC staff identifying specific issues and questions for consultation was published with the rule change request.

The period for submissions on the first round of consultation closed on 22 May 2014.

The Commission received five submissions; each is available on the AEMC website. A summary of issues raised in these submissions, and the Commission's responses, is provided at Appendix C.

1.7 Commencement of final rule

The Commission has considered stakeholder views regarding the commencement of any final rule. To provide policy certainty to service providers and the economic regulators, the Commission considers it appropriate that the final rule, if made, should commence on publication, currently anticipated to occur in early October 2014.

1.8 Consultation on draft rule determination

The Commission invites submissions on this draft rule determination by 21 August 2014.

Any person or body may request the Commission to hold a hearing in relation to the draft rule determination.¹⁰ Any request for a hearing must be made in writing and must be received by the Commission no later than 17 July 2014.

Submissions and requests for a hearing should quote project number "GRC0025" and may be lodged online at www.aemc.gov.au or by mail to:

Australian Energy Market Commission
PO Box A2449
SYDNEY SOUTH NSW 1235

⁹ *ibid*, [54-55].

¹⁰ In accordance with s. 310(2) of the NGL. A public hearing is a formal requirement for the Commission to appear before the applicant to enable the applicant to make a presentation to the Commission.

2 Draft rule determination

2.1 Commission's draft rule determination

The Commission's draft rule determination is to make the proposed rule as submitted by the AER, subject to a minor typographical correction. Detailed reasons for the Commission's decision to make this draft rule determination are set out in Chapter 3. The draft rule is attached to and published with this draft rule determination.

The reasons for making this draft rule determination are:

- the draft rule preserves the incentive framework of the regulatory regime;
- the draft rule will safeguard against gains or losses not related to the efficiency of service providers from impacting on pipeline investment and usage incentives;
- under the draft rule, reference tariffs will be more likely to reflect efficient utilisation of, and investment in, natural gas services and will be less likely to be distorted by gains or losses unrelated to the efficiency of service providers; and
- the draft rule will reduce the current uncertainty about the methodology an economic regulator must use when setting the opening capital base.

2.2 Rule-making test

The Commission may only make a rule if it is satisfied that the rule will, or is likely to, contribute to the achievement of the NGO.¹¹

The NGO states:

“The objective of this Law is to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.”

The Commission considered that the relevant aspects of the NGO in the context of this rule change request are:

- the efficient use of natural gas services; and
- the efficient investment in natural gas services.

The efficient use of, and investment in, natural gas services promotes the long term interests of consumers by establishing a regulatory framework in which consumers do not pay for the inefficient use of, or investment in, natural gas services and by

¹¹ See s. 291(1) of the NGL.

requiring tariffs to be based on the efficient costs of an efficient and prudent service provider.

Efficient use of, and investment in, natural gas services

The Commission considers the draft rule will remove the potential for service providers to experience gains or losses associated with the difference between estimated and actual capital expenditure. This preserves the operation of the incentive framework of the regulatory regime. Under the current rules, service providers may be exposed to unallocated risks and gas customers may be exposed to tariff pricing that is higher than efficient levels.

Regulatory certainty and transparency

The Commission also considers the draft rule may contribute to greater regulatory certainty. If the rule was not amended, the present uncertainty arising from the differing outcomes of the recent Tribunal decisions regarding whether the AER has the power to make the relevant adjustment, may continue. The Commission considers the draft rule may provide service providers, and gas users generally, with greater regulatory certainty and transparency about the scope and application of rule 77(2)(a).

2.3 Consistency with the revenue and pricing principles

The AEMC must take into account the revenue and pricing principles in making a rule with respect to any matter specified in items 40 to 48 of Schedule 1 to the NGL.¹² Items 40 and 43 apply to this draft rule. Having regard to the issues raised by the proposed rule, the Commission has considered each of the relevant revenue and pricing principles. The Commission is satisfied that the draft rule is consistent with the revenue and pricing principles.

The revenue and pricing principles state that service providers should be provided with a reasonable opportunity to recover at least the efficient costs they incur in providing reference services and complying with a regulatory obligation or requirement or making a regulatory payment.

The Commission considers that the draft rule will not affect the opportunity of service providers to recover the efficient costs of providing reference services. Under circumstances in which there is a material difference between estimated and actual capital expenditure in the final year of an access arrangement period, service providers have the opportunity to recover the efficient costs of conforming capital expenditure at the next setting of the opening capital base.

Further, the Commission is of the view the draft rule will not undermine the incentives that service providers have to provide reference services efficiently. The overall incentive framework remains unchanged. The forecast incentive framework remains unaffected by the draft rule.

¹² NGL, s. 293.

The revenue and pricing principles also provide that regard should be had to the economic costs and risks of the potential for under- and over-investment by a service provider in a pipeline with which the service provider provides pipeline services. Regard must also be had to under- and over-utilisation of a pipeline with which a service provider provides pipeline services.

The Commission considers the draft rule will provide greater certainty to investors in pipeline services and provide appropriate signals with respect to the utilisation of pipelines by preventing service providers from experiencing benefits or losses arising out of a difference between estimated and actual final year capital expenditure.

By providing a mechanism for the recovery of efficient costs of conforming capital expenditure in the case of an under-estimate and a resulting higher actual spend in the final year of an access arrangement period, the draft rule effectively takes into account the risk for under- and over-investment in, and utilisation of, pipeline services.

Further explanation of the revenue and pricing principles and how they apply to this draft rule is set out in Appendix A of this draft rule determination.

2.4 Strategic priority

This rule change request relates to the AEMC strategic gas priority to promote the development of efficient gas markets. It affects the manner in which service providers recover the efficient costs of providing reference services provided by a pipeline. This rule change request, therefore, also affects the prices that consumers of natural gas ultimately pay for their gas services.

3 Commission's assessment

This chapter explains the Commission's analysis and reasons for making the draft rule and responds to stakeholder submissions.

Stakeholder submissions to the consultation paper ranged in response from clear support for the proposed rule, support for a more preferable rule, unsupportive of either, and preference for an entirely different approach to solving the issue raised by the AER in its rule change request. The Commission considered each submission closely and responds here to the key points raised by stakeholders.

The Commission's responses to these and other issues raised in submissions are included in Appendix C.

3.1 Preserving the incentive framework of the regulatory regime

The Commission considers that the draft rule preserves the incentive-based regulatory framework and acts to discourage the potential for inefficient, adverse incentives that are not in the long term interests of consumers.

The building block approach to determining total revenue, which in turn is used to set reference tariffs, is part of a regulatory regime that is designed to encourage service providers to pursue capital expenditure efficiencies within each access arrangement period. As noted in the AER's rule change request, the framework operates to enable service providers the opportunity to earn a return on the projected capital base for each year of an access arrangement period, which includes the opening capital base and forecast conforming capital expenditure.¹³

The function of this incentive framework is to encourage service providers to seek efficiencies that may contribute to lower prices for consumers over the long-term.

The Commission considers that the interpretation of rule 77(2)(a) by the Tribunal in the APA GasNet decision, which is that the AER is not entitled to make an adjustment for any benefit or penalty associated with any difference between the estimated and actual capital expenditure, has the potential to impact on the incentive framework of the regulatory regime. By not requiring the economic regulator to make the relevant adjustment, service providers may be encouraged to over-estimate their capital expenditure in the final year of an access arrangement period because of the incentive to pursue revenue maximisation (by earning a return on the over-estimated capital expenditure).

This potentially adverse incentive may also encourage service providers to defer efficient capital expenditure into the next access arrangement period in preference to pursuing a return on capital associated with the estimated capital expenditure.

¹³ AER rule change proposal, 11 November 2013, p8.

Conversely, if a service provider under-estimated its capital expenditure in the final year of an access arrangement period, and ultimately spent materially more in that period, it currently may not have the opportunity to recover its efficient costs. This is because the service provider would receive a return based on the lower estimated capital expenditure and not the higher actual capital expenditure. This result would not be in accord with the revenue and pricing principles and would adversely affect the ability of service providers to recover their economic costs.

Under the draft rule, service providers would be made whole by allowing a return on capital on actual conforming capital expenditure, even in a circumstance in which the actual conforming capital expenditure spent in the final year of an access arrangement period is more than the estimated capital expenditure.

The Commission considers that the draft rule effectively removes the potential for service providers to experience gains or losses associated with the difference between estimated and actual capital expenditure and preserves the operation of the incentive framework of the regulatory regime. Failure to remove the potential for these gains or losses to occur would expose service providers to new, likely unallocated risks and expose customers to tariff pricing that does not reflect the efficient cost of providing the reference service.

3.2 Regulatory certainty and transparency

The Commission has also considered the importance of regulatory certainty and transparency in the methodologies used by the economic regulators to contributing to a stable investment environment and the promotion of the NGO. The ability of the AER to make the relevant adjustment has twice been the subject of dispute between the AER and certain service providers at the Tribunal. As a result, the economic regulators and the service providers may be uncertain about the scope of rule 77(2)(a).

As noted above, in 2011 the Tribunal decided that an adjustment to the return on capital associated with the difference between estimated and actual capital expenditure could be made by the AER (the Jemena decision).¹⁴ However, in 2013 the Tribunal decided that the AER was not empowered to make the relevant adjustment (the GasNet decision).¹⁵ Subsequently, the AER announced its intention to submit this rule change request.¹⁶ The Commission is mindful of the uncertainty that is evident from the relevant Tribunal decisions.

In their submissions to the consultation paper, both ENA and Jemena considered that the proposed rule would provide clarity about the relevant adjustment.¹⁷ ENA also noted that the proposed rule is a proportionate response to the issues raised by the

¹⁴ Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] A CompT6 (Jemena decision).

¹⁵ Application by APA GasNet (Operations) Pty Ltd (No 2) [2013] A CompT8 (APA GasNet decision).

¹⁶ See AER media release here: <https://www.aer.gov.au/node/21868>.

¹⁷ Jemena submission, 22 May 2014, p1; ENA submission, 23 May 2014, p2.

relevant 2011 and 2013 Tribunal decisions and may "materially improve predictability in the operation of the capital base provisions of the NGR".¹⁸

If the current rule is not amended, the uncertainty arising from the differing outcomes of the recent Tribunal decisions regarding whether the AER has the power to make the relevant adjustment will persist.

The Commission considers the draft rule will address this uncertainty and provide greater transparency about the methodology the economic regulators will utilise when setting the opening capital base and thereby further promote the NGO.

3.3 APA and APIA submissions

Both APA Group (APA) and the Australian Pipeline Industry Association (APIA) indicated in their respective submissions that they did not support the proposed rule. These stakeholders raised a number of issues, which are discussed below.

APA Group submission

APA argued that the rule change request is unnecessary and risks creating a circumstance in which service providers may not be given a reasonable opportunity to recover the efficient costs in providing reference services.¹⁹ APA submitted that this circumstance may arise where a delay in timing of a project would see the service provider not receiving a return until the start of the access arrangement period that follows.²⁰

APA presented the following grounds to support this argument:

- the proposed rule change is unnecessary given the assessment requirements under the NGR and current AER regulatory practices to assess the accuracy, prudence and efficiency of forecasts and estimates;
- the proposed rule may deny service providers the opportunity to recover the efficient costs in providing reference services; and
- the proposed rule does not adequately account for the interrelated nature of estimated and forecast capital expenditure, particularly where it relates to capital projects that span two access arrangement periods.

18 ENA submission, 23 May 2014, pp1-2.

19 APA submission, 21 May 2014, p4.

20 *ibid.*

First, the Commission notes that the relevant assessment requirements under the NGR and the AER's regulatory practices should, when effectively implemented, mitigate the risk of inflated estimates of capital expenditure being proposed in the final year of an access arrangement period.²¹

Nonetheless, given the inherent information asymmetries between service providers and the economic regulator, the Commission is of the view that when capital expenditure estimates differ from actual capital expenditure, there should be a clear mechanism in the NGR requiring the economic regulator to remove any benefit or penalty associated with that difference.

In regard to APA's second point, the Commission considers that the draft rule would not operate to deny service providers the opportunity to recover the efficient costs in providing reference services. Rather, the Commission considers the draft rule, if implemented, will better enable service providers to have the opportunity to recover the efficient costs of conforming capital expenditure for the reasons outlined at section 3.1 above.

The Commission has also considered the potential impact of the draft rule on projects that span two access arrangement periods and interactions between forecast and estimated capital expenditure. APA argues in its submission to the consultation paper that under the proposed rule a project delay occurring in the final year of an access arrangement period that results in capital expenditure being delayed and spent in the subsequent access arrangement period would mean the service provider would not receive a return on the actual expenditure until the start of the following access arrangement period.

In assessing this potential outcome, it is important to bear in mind the other events that must also occur to realise the circumstance APA raises. First, although the Commission is aware of the occurrence of this issue in two instances (the Jemena decision and the APA decision), material differences between estimated and actual capital expenditure in the final year of an access arrangement period would not be expected to be common.

Given the requirements of rule 74 of the NGR, and the apparent practice of the AER to require a statutory declaration to accompany estimates of capital expenditure,²² it is reasonable to expect estimates to be well-developed.²³

In addition, given the nature of the assessment process for a revised access arrangement, service providers prepare and submit a revised proposal typically three months before the regulator makes its final decision. For example, for a typical five year access arrangement period spanning the years 2005 to 2010, the service provider

²¹ Rule 74 requires that (1) forecasts and estimates to be accompanied by a statement of the basis of the forecast or estimate and (2) a forecast or estimate must be arrived at on a reasonable basis; and must represent the best forecast or estimate possible in the circumstances.

²² See AER access arrangement final decision, APA GasNet Australia (Operations) Pty Ltd 2013-17, Part 3: Appendix C, 2.2, p84.

²³ See AER rule change proposal, 11 November 2013, p5.

would provide an update of costs (including estimated capital expenditure) in approximately September 2009.

These two factors limit the scope for the difference between estimated and actual capital expenditure to be significant. They also clearly limit the likelihood that material, conforming capital expenditure would remain in a state of uncertainty as to whether it will be incurred over the next three months or during the next access arrangement period.

However, it is possible that a material difference between estimated and actual capital expenditure could occur for good reason beyond the last revision submitted by a service provider. If this difference was actually incurred in the next access arrangement period, the service provider would not forgo the opportunity to recover the efficient costs because, subject to being conforming capital expenditure, it would be rolled into the subsequent capital base with an adjustment made to remove any benefit or penalty that results from the difference between estimated and actual capital expenditure.

Moreover, in circumstances where a service provider suffers a detriment as a result of an underestimation of capital expenditure relative to actual capital expenditure, the draft rule would operate to remove this detriment. The service provider would be 'made whole' by providing it with a return on capital on conforming capital expenditure in the access arrangement period.

At most, it appears a service provider's decision to delay the spend of capital expenditure to the next access arrangement period would result only in the delay of receiving the associated compounded return on capital until the start of the following access arrangement period.

The delay of capital expenditure spend across an access arrangement period will result in a later receipt of the associated return on capital. This is consistent with the overarching incentive framework, which is designed to provide service providers with a return on the projected capital base for each year of an access arrangement period based on forecast conforming capital expenditure and the opening capital base.²⁴

In its rule change request, the AER indicated that the equivalent provisions of the Gas Code provided the power to make the relevant adjustment and that this did occur.²⁵

The ERA has indicated that this issue has not yet arisen in Western Australia due to its ability to substitute actuals for any estimates before it has made final decisions.²⁶

²⁴ AER rule change proposal, 11 November 2013, p8.

²⁵ AER rule change proposal, 11 November 2013, p12 and note 40.

²⁶ ERA submission, 30 May 2014, p2.

APIA submitted that the AER's argument to make the relevant adjustment in the case of estimated capital expenditure, but not calling for an adjustment of forecast capital expenditure, is illogical.²⁷ However, this view appears to assume 'estimate' and 'forecast' are synonymous. Although forecasts and estimates may share some similarities in form, such as their mutually uncertain nature and their requirement to be arrived at on a reasonable basis,²⁸ they are functionally different under the NGR.

Forecast capital expenditure is expenditure that is anticipated to occur in a future access arrangement period. Part of the incentive framework of the regulatory regime involves including forecast capital expenditure that is expected to satisfy the conforming capital expenditure test in the projected capital base, and therefore part of the service provider's total revenue.

If a service provider's actual capital expenditure is less than forecast in a relevant access arrangement period, the service provider will retain the return on capital on that forecast for the remainder of that access arrangement period. The service provider also receives a depreciation allowance on forecast capital expenditure.

This framework creates the ongoing capital expenditure efficiency incentive, which allows service providers to keep an incremental rate of return on the difference over the access arrangement period. The efficiency dividend of outperforming forecasts is then passed on to consumers via lower than otherwise tariffs at the beginning of the next access arrangement period following the substitution of forecast for actual capital expenditure.

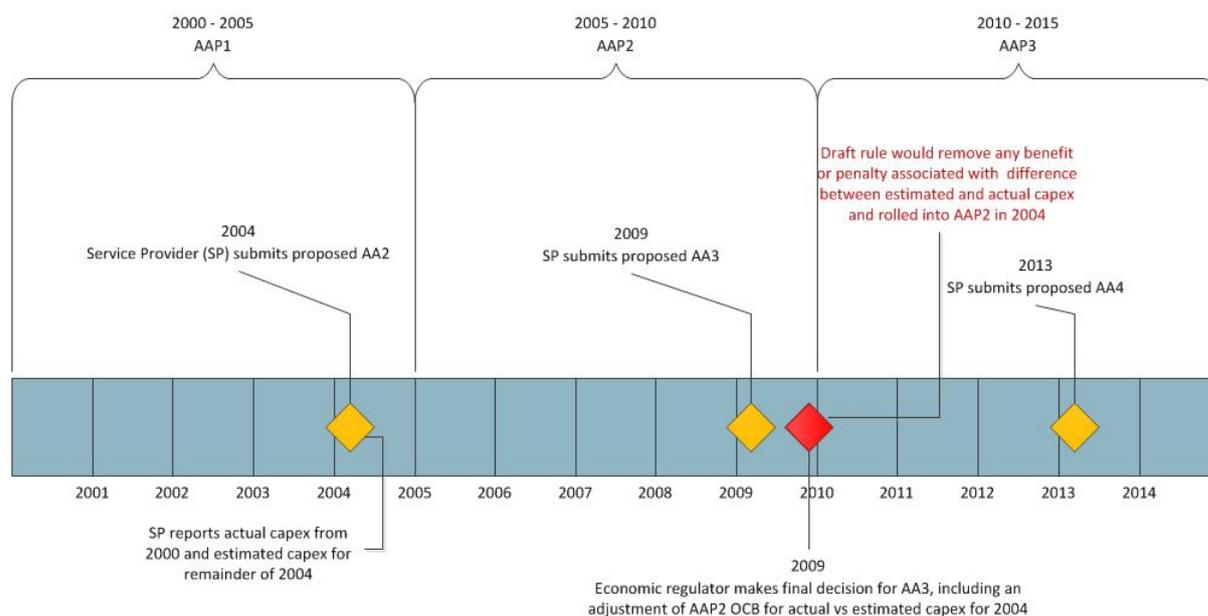
Unlike the express adjustment mechanism to account for differences between estimated and actual capital expenditure under rule 77(2)(a), the economic regulator does not make an adjustment for return on capital for the difference between forecast and estimated capital expenditure occurring, for example, as a service provider moves from one access arrangement period to the next.

The figure below illustrates an example of the context in which an adjustment to the opening capital base would be made under the draft rule to remove any benefit or penalty arising out of the difference between estimated and actual capital expenditure in the final year of a relevant access arrangement period.

²⁷ APIA submission, 22 May 2014, p1.

²⁸ See rule 74.

Figure 3.1 Access arrangement submission time line and decision points



Estimated capital expenditure is expenditure planned to be incurred in the final year of a current access arrangement period. Service providers must estimate relevant capital expenditure in the final year of an access arrangement period because of the economic regulators' practice to finalise the future revised access arrangement prior to the end of the current access arrangement period to create a smooth transition between periods.

Accordingly, the incidence of estimated capital expenditure is borne out of administrative necessity and its function is to act as a placeholder for actual capital expenditure. Estimated capital expenditure is not intended to form part of the overall regulatory incentive framework. However, as a result of the decision in APA GasNet, estimated capital expenditure will, unless the proposed rule is made, take on an incentive property and may potentially impact on the incentive framework of the regulatory regime.

Because of the differences between forecast and estimated capital expenditure, the Commission considers it appropriate that they are treated differently by the economic regulator.

APIA also argued that the proposed rule would create perverse investment incentives and could lead to regulatory gaming if service providers sought to incur capital expenditure in the final year of an access arrangement period that is higher than the estimate.²⁹ The Commission considers the impact the draft rule would have, if implemented, on service providers' behaviour to pursue other than efficient investment decisions is minimal.

²⁹ APIA submission, 22 May 2014, p5.

First, such behaviour would be likely to impact negatively on service providers' incentive to outperform their forecast capital expenditure. Second, the approach under the draft rule reflects the limited historical practice.³⁰ Third, the economic regulators are appropriately empowered with limited discretion to scrutinise imprudent, inefficient or unreasonable capital expenditure estimates, coupled with the ability to request information through a regulatory information notice.³¹

Last, the information and statement requirements of rule 74 for estimates and forecasts, and the fact that only conforming capital expenditure is rolled into the capital base, also act as checks on the risk that inefficient capital expenditure could be rolled into the opening capital base.

3.4 Proposed commencement date

In its submission to the consultation paper, Jemena Gas Networks (JGN) expressed its preference that any final rule made would apply from the date of publication of the rule change request -- that is, 17 April 2014.

JGN submitted that the retrospective application of any final rule to this date would provide added certainty to service providers currently preparing revised access arrangement proposals. JGN is currently preparing its revised access arrangement proposal for the period 2015-2020 for lodgement with the AER on 1 July 2014.

JGN supports the need for the rule change, submitting that it is non-controversial and was foreshadowed by the AER in September 2013, following the Tribunal's APA GasNet decision.³²

However, the Commission considers retrospective rulemaking is not good regulatory practice generally, and particularly where it would involve applying a rule to revenues generated prior to the commencement of the rule. While JGN has expressed the view that it would accept retrospective application of the proposed rule, the Commission is mindful that JGN is not the only service provider in the position of preparing a revised access arrangement proposal. For example, the Goldfields Gas Transmission pipeline in Western Australia is also due to propose a revised access arrangement, likely covering the period 2015-2019.

The Commission is of the view that to apply retrospectively any final rule without clear evidence of a compelling reason would increase service provider and investor uncertainty. It would also undermine, and be inconsistent, with the NGO.

The Commission has therefore decided that the commencement of any final rule should occur on its publication, currently anticipated in early October 2014. Stakeholder views on this are welcomed.

³⁰ See AER rule change proposal, 11 November 2013, p12.

³¹ See, for example, rule 79 and s. 46 of the NGL.

³² JGN submission, 22 May 2014, p2.

4 Alternatives to proposed rule

This chapter examines the potential alternatives to the proposed rule that were raised in the consultation paper and submissions to the consultation paper. This includes making a corresponding rule to the NER.

4.1 More preferable rule

Because of the background to this rule change request, the Commission considered it would be useful to consult on making a more preferable rule that was more targeted than the proposed rule.

In order to make a more preferable rule, the Commission must be satisfied that, having regard to the issue or issues raised by the AER's proposed rule, the more preferable rule will, or is likely to, better contribute to the NER.

One alternative to the proposed rule raised in the consultation paper is to make a more preferable rule that focuses the ability of the economic regulator to make the relevant adjustment to associated return on capital only, instead of the broader "benefit or penalty" stated in the proposed rule. A number of stakeholders indicated their qualified support for this approach, broadly suggesting a more preferable rule that was confined expressly to return on capital would provide greater certainty and transparency.³³

The Commission is of the 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. It is also considered 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.

The consultation paper also raised the potential to make a corresponding rule to the relevant part of the NER. Because the Commission has decided not to make a more preferable rule, the potential to make a corresponding rule does not arise.³⁴

In their rule change request, the AER argued that alignment between the electricity and gas regimes is desirable where appropriate.³⁵ Both APIA and APA submitted that this

³³ See JGN submission, 22 May 2014, p1; APA submission, 21 May 2014, p5; ENA submission, 23 May 2014, p1; APIA submission, 22 May 2014, p4.

³⁴ For distribution network service providers, see clauses S.6.2.1(c)(2) and S.6.2.1(e)(3) of the NER; for transmission network service providers, see clauses S.6A.2.1(c)(2) and S.6A.2.1(f)(3) of the NER. That is, to result in the amended wording referring to the return on capital being included in not only rule 77(2)(a), but also in clauses S.6.2.1(c)(2), S.6.2.1(e)(3), S.6A.2.1(c)(2), and S.6A.2.1(f)(3) of the NER.

³⁵ AER rule change proposal, 11 November 2013, pp11-12.

is not a relevant consideration or a desirable outcome for this rule change proposal.³⁶ ENA expressed qualified support to make a corresponding rule.³⁷

The Commission notes that where alignment between the electricity and gas regulatory regimes is appropriate and adapted to the circumstances, positive administrative and other efficiencies may emerge that benefit all parties.

Lastly, the ERA, in its submission to the consultation paper, proposed a different approach to resolving the issue raised by the AER. This alternative approach is considered in detail in section 4.1.1 below.

4.1.1 ERA's alternative approach

The ERA provided a submission that supported the basis for the AER's rule change request, but suggested a different approach to solving the problem identified. The approach preferred by the ERA is to change the NGR to provide the economic regulator with the power to make the relevant adjustment as a one-off cash flow adjustment to the first year in the applicable access arrangement period, or, alternatively, to apply the adjustment in a present value neutral way over the applicable access arrangement period.³⁸

The ERA submitted that the approach under the proposed rule would result in a slow and drawn out adjustment taking effect over the life of the relevant assets in the capital base. This is because of the practice of multiplying the rate of return by the projected capital base.³⁹

The ERA considers its preferred approach of a cash flow adjustment would allow the economic regulator and service providers to deal with the adjustment as soon as practicable and provide clarity to all parties. Under this approach, prices would revert to efficient levels faster (that is, year one of the relevant access arrangement period or spread across the access arrangement period). This would provide appropriate economic signals to customers and be consistent with the NGO. The ERA also submitted that its preferred approach would be a quicker, cleaner method of accomplishing the same objective of the AER's proposed rule.⁴⁰

However, the ERA noted that under its preferred approach there is the potential for greater price variation in the short term as a result of applying the relevant adjustment to the cash flows.⁴¹ The degree of price variation would vary according to whether the adjustment was completed in the first year of the relevant access arrangement period

³⁶ APIA submission, 22 May 2014, p1; APA submission, 21 May 2014, p5.

³⁷ ENA submission, 23 May 2014, p1.

³⁸ ERA submission, 30 May 2014, p3.

³⁹ *ibid.*

⁴⁰ *ibid.*

⁴¹ *ibid.*

or if the adjustment was smoothed out across the entire access arrangement period. It would also depend on the amount of the adjustment required.

On balance, the Commission has decided that the AER's proposed approach to making the relevant adjustment should be preferred over the ERA's approach because:

- the efficiency benefits to be gained by using a more direct, one-off method of adjustment are outweighed by the potential impacts of price variations where material differences between estimated and actual capital expenditure do occur; and
- adding a new, untested process to the building block approach would create additional administrative burden on service providers and the economic regulators relative to the alternative.

In addition, the Commission notes that given the background examined above, service providers and the AER have some experience and familiarity complying with and understanding the operation of the draft rule. The ERA approach would involve adding a new process to a different rule than that proposed by the AER to effect the same outcome. The draft rule avoids the necessity to change the building block components and also avoids the potential for price shocks that could result from a one-off cash flow adjustment.

The Commission considers the draft rule is functional, relatively familiar to service providers and the economic regulators, and simple to apply.

Abbreviations

AAP	access arrangement period
ACT	Australian Competition Tribunal
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
APIA	Australian Pipeline Industry Association
Commission	See AEMC
COAG	Council of Australian Governments
ENA	Energy Networks Association
ERA	Energy Regulation Authority
JGN	Jemena Gas Networks
MCE	Ministerial Council on Energy
NEL	National Electricity Law
NER	National Electricity Rules
NGL	National Gas Law
NGO	national gas objective
NGR	National Gas Rules
OCB	opening capital base
RPP	revenue and pricing principles
SCER	See COAG Energy Council

A Legal requirements under the NGL

This appendix sets out the relevant legal requirements under the NGL for the AEMC to take into account in making this draft rule determination.

A.1 Draft determination

In accordance with s. 308 of the NGL, the Commission has made this draft rule determination in relation to the rule proposed by the AER.

A.2 Commission's power to make the rule

The Commission is satisfied that the draft rule falls within the subject matter about which the Commission may make rules, as set out in s. 74 of the NGL.

Specifically, the draft rule relates to regulatory economic methodologies and the economic regulatory function or powers in respect of the regulatory economic methodologies (including the building block approach), as specified in item 40 of Schedule 1 to the NGL, to be applied by the economic regulator in approving or making revisions to an applicable full access arrangement.

The draft rule also relates to the capital base with respect to a covered pipeline, and of a new facility for the purposes of approving revisions or a variation to an applicable access arrangement that is a full access arrangement.⁴²

Further, the draft rule affects the way in which the economic regulator performs or exercises an economic regulatory function or power, including the basis on which it makes an economic regulatory decision.⁴³

Lastly, the draft rule also affects the principles to be applied, and the procedures to be followed, by the economic regulator in exercising or performing an economic regulatory function or power.⁴⁴

A.3 Revenue and pricing principles

In applying the rule making test under s. 291(1) of the NGL, the Commission has taken into account the revenue and pricing principles as required under s. 293 of the NGL because the draft rule relates to matters specified in items 40 and 43 of Schedule 1 to the NGL.

The revenue and pricing principles are set out in s. 24 of the NGL. They set out a number of principles concerning matters such as the recovery of efficient costs,

⁴² See item 43 of Schedule 1 to the NGL.

⁴³ See item 49 of Schedule 1 to the NGL.

⁴⁴ See item 50 of Schedule 1 to the NGL.

incentives to promote efficiencies, and the principle that prices should reflect returns commensurate with the risks involved in providing the relevant services.

Under s. 293 of the NGL, the AEMC is required to take into account the revenue and pricing principles in certain cases. This draft rule determination is such a case. Having considered the issues raised by the AER, the proposed rule, and submissions to the consultation paper, the Commission has concluded that the draft rule is consistent with the revenue and pricing principles

Section 24(2)(a) of the NGL, relevantly, states that service providers should be provided with a reasonable opportunity to recover at least the efficient costs they incur in providing reference services. The Commission considers that the draft rule will not affect the opportunity of service providers to recover at least the efficient costs they incur in providing reference services.

The revenue and pricing principles in s. 24 of the NGL also state that service providers should be provided with effective incentives in order to promote economic efficiency with respect to the reference services they provide.⁴⁵ The economic efficiency that should be promoted includes:

- efficient investment in, or in connection with, a pipeline with which the service provider provides reference services;
- the efficient provision of pipeline services; and
- the efficient use of the pipeline.

For example, by providing for the ability to recover efficient costs of conforming capital expenditure in the case of an under-estimate and a resulting higher actual spend in the final year of an access arrangement period, the draft rule effectively promotes the efficient use of, and investment in, pipelines and the efficient provision of pipeline services.

The revenue and pricing principles also requires regard to be had to the economic costs and risks of the potential for under- and over-investment by a service provider in a pipeline with which the service provider provides pipeline services. It also requires consideration of the economic costs and risks of the potential for under- and over-utilisation of a pipeline with which a service provider provides pipeline services.⁴⁶

As noted in Chapter 3, the Commission considers the draft rule will provide greater certainty to investors in pipeline services, and provide appropriate signals with respect to the utilisation of pipelines. This will be achieved by preventing service providers from experiencing benefits or losses arising out of a difference between estimated and actual final year capital expenditure.

⁴⁵ See NGL, s. 24(3).

⁴⁶ See NGL, ss. 24(6)-(7).

A.4 Participating jurisdictions

The draft rule, if implemented, would apply to each participating jurisdiction, including Western Australia. Under s. 21 of the NGL, the participating jurisdictions are the states, the Commonwealth, the Australian Capital Territory and the Northern Territory. The draft rule applies in Western Australia as it falls within the subject matters about which the Commission may make rules under the *National Gas Access (WA) Act 2009*.

A.5 Commission's considerations

In assessing the rule change request, the Commission had regard to:

- the Commission's powers under the NGL to make the rule;
- the rule change request;
- the fact that there is no relevant Ministerial Council on Energy (MCE) Statement of Policy Principles;
- submissions received during the first round consultation;
- the ways in which the proposed rule will, or is likely to, contribute to the achievement of the NGO; and
- the revenue and pricing principles.

B Regulatory approach

This appendix discusses briefly the relevant current economic regulatory approach and fundamental elements of the methodology used by the economic regulators when setting the opening capital base under the NGR.

B.1 Setting the opening capital base

Under rule 76 of the NGL, the total revenue for each year of an access arrangement period is derived using the building block approach that combines:

- a return on the projected capital base for the year;
- depreciation on the projected capital base for the year;
- the estimated cost of corporate income tax for the year;
- increments or decrements for the year resulting from the operation of an incentive mechanism to encourage gains in efficiency; and
- a forecast of operating expenditure for the year.

Once determined, total revenue is used, with demand information over the access arrangement period, to calculate the reference tariff for each reference service.

Rule 78 defines the projected capital base component of total revenue to comprise:

- the opening capital base; plus
- forecast conforming capital expenditure for the period; less
- forecast depreciation for the period; and
- the forecast value of pipeline assets to be disposed of in the course of the period.

The opening capital base is the value of a service provider's regulated assets at the beginning of an access arrangement period. The method the economic regulator must use when calculating the opening capital base is determined by rule 77 of the NGR.

In order to calculate the opening capital base for the next access arrangement period, it is necessary to begin by determining the opening capital base at the commencement of the current access arrangement period and make a number of adjustments reflecting changes that have occurred during the period. Relevantly, this includes an adjustment for any difference between the estimated and actual capital expenditure for the final year of the preceding access arrangement period included in that opening capital base.

Under rule 77(2), if an access arrangement period follows immediately on the conclusion of a preceding access arrangement period, the opening capital base for the later access arrangement period is to be:

- the opening capital base as at the commencement of the earlier access arrangement period (adjusted for any difference between estimated and actual capital expenditure included in that opening capital base); plus
- conforming capital expenditure made, or to be made, during the earlier access arrangement period; plus
- any amounts of capital expenditure to be added to the capital base under rules 82, 84, or 86; less
- depreciation over the earlier access arrangement (to be calculated in accordance with any relevant provisions of the access arrangement governing the calculation of depreciation for the purpose of establishing the opening capital base); and
- redundant assets identified during the course of the earlier access arrangement period; and
- the value of pipeline assets disposed of during the earlier access arrangement period.

B.2 Capital expenditure

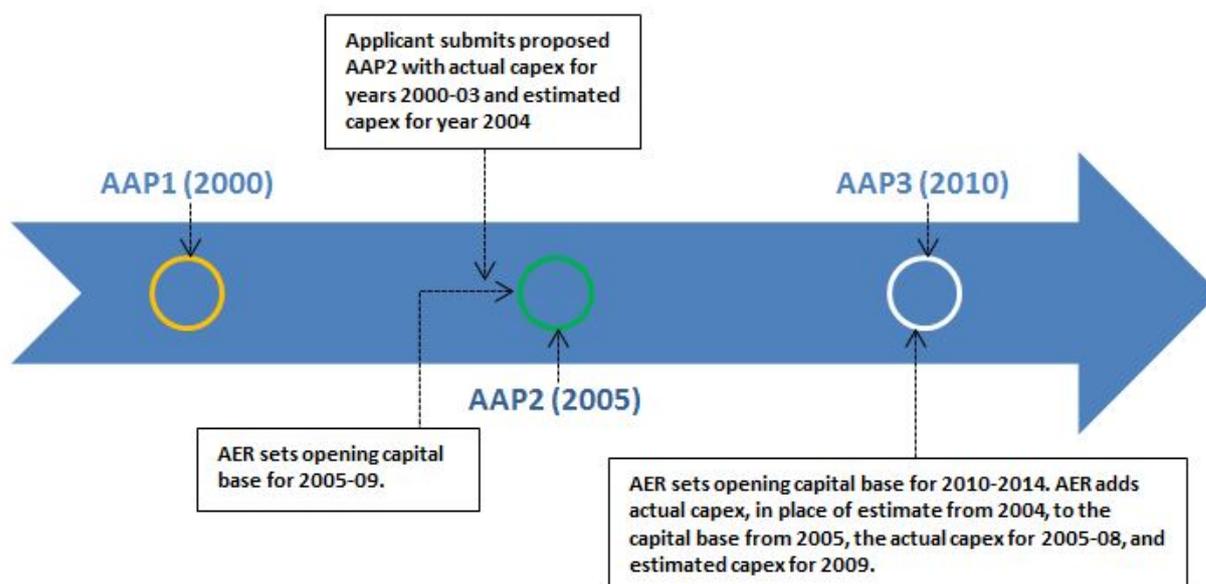
Capital expenditure is defined by the NGR to mean those costs and expenditures of a capital nature incurred to provide, or in providing, pipeline services. This includes expenditure on compressors, looping and extensions to the pipeline (that is, the construction of physical assets).

Due to timing constraints around the submission of a proposed revised access arrangement, it is not possible for a service provider to report actual capital expenditure for the final year of the current access arrangement period as the year has yet to end.

For this reason, the opening capital base often includes an actual capital expenditure for the earlier years of an access arrangement period (for example, years one to four of a five year period) and an estimated capital expenditure for the final year of the access arrangement period (for example, year five). This estimate will include actual capital expenditure to the extent available and an estimate of what is proposed to be incurred over the remainder of the final year, which may only be the final three months of the access arrangement period.

The time line below depicts an example of when this may occur.

Figure B.1 Example access arrangement proposal submission and decision time line



In its rule change, the AER included request an example that demonstrates the impact of the proposed rule change, in which the access arrangement covers the following hypothetical periods:

- access arrangement period 1 (AAP1) - years 1-5
- access arrangement period 2 (AAP2) - years 6-10
- access arrangement period 3 (AAP3) - years 11-15

The initial opening capital base for AAP1 is assumed to be set in year zero and revised at the end of the final years of each access arrangement period (that is, years 5, 10, and 15).

The AER notes that when setting the opening capital base for year 11 in AAP3, it has been its practice to make both the difference and return on capital adjustments to the capital base to account for the difference between the year five capital expenditure estimate and the actual value of capital expenditure in year five. Year 11 of AAP3 is the first opportunity for an adjustment to return on capital, accumulated over years 6-10, to be made under the proposed rule.

The relevant adjustment, as proposed, would involve removing or adding to the opening capital base for year 11 the accumulated gain or loss that arises out of any difference between the estimated and actual capital expenditure for the final year (year five) of AAP1.

B.3 Return on capital

Return on capital forms part of the building block approach to determining the revenue of a service provider. Calculating the return on capital is done by multiplying the allowed rate of return by the opening capital base for each year of the access arrangement period, resulting in an accumulated rate of return.

The allowed rate of return is determined according to rule 87 of the NGR, which stipulates that it is to be determined such that it achieves the allowed rate of return objective. The allowed rate of return objective requires that the rate of return for a service provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services.

C Summary of issues raised in submissions to consultation paper

Stakeholder	Issue	AEMC response
<p>APA Group (APA)</p>	<p>APA submits the proposed rule change is unnecessary given the assessment requirements under the NGR and current AER regulatory practices to assess the accuracy, prudence and efficiency of forecasts and estimates. APA also contends that the risk of inflated estimates is overstated and capable of being addressed under the regulatory regime using existing powers.</p> <p>APA submits that the proposed rule change may deny service providers the opportunity recover their efficient costs in providing reference services. It is argued that the proposed approach does not adequately account for the interrelated nature of estimated and forecast capital, particularly where it relates to projects that span two regulatory periods.</p> <p>APA submits that the proposed rule is very broad and adjustments are not necessarily confined to revenue associated with return on capital in respect of estimates. APA submits the proposed rule, if made, should be revised to make clear the scope of the proposed adjustment.</p> <p>APA notes the AER cites alignment with the electricity regime as a supporting factor for the rule change proposal. However, APA does not consider that consistency between the electricity and gas regimes is a relevant consideration and submits there are clear and purposeful differences between the two regulatory regimes.</p>	<p>The relevant assessment requirements under the NGR and the AER's regulatory practices should, when effectively implemented, mitigate the risk of inflated estimates of capital expenditure in the final year of an access arrangement period.</p> <p>Nonetheless, when relevant capital expenditure estimates differ from actual capital expenditure, there should be a clear mechanism in the NGR requiring the economic regulator to remove any benefit or penalty associated with that difference.</p> <p>The Commission considers that the draft rule will not operate to deny service providers the opportunity to recover efficient costs in providing reference services. Rather, it would aid the economic regulator in providing service providers the opportunity to recover efficient costs.</p> <p>The Commission has decided the draft rule is sufficiently clear in its scope and application and provides the economic regulator with appropriate discretion.</p> <p>The Commission notes some stakeholders place a value on the common treatment of similar economic regulatory practices under the NER and the NGR. However, consistency between the two regimes on this topic was a secondary consideration in this decision.</p>

Stakeholder	Issue	AEMC response
<p>Australian Pipeline Industry Association (APIA)</p>	<p>APIA submitted the following primary reasons for not supporting the rule change request:</p> <ul style="list-style-type: none"> • the AER's arguments for the relevant adjustment in the case of estimated capital expenditure, but against an adjustment of forecast capital expenditure, are illogical; • the drafting of the proposed rule is such that it could apply to broader range of benefits and penalties than AER seeks to address; • the AER does not appreciate the way in which its proposed rule creates perverse investment incentives and could lead to regulatory gaming. 	<p>The Commission notes:</p> <ul style="list-style-type: none"> • in the context of the NGR regulatory framework, there is a difference between estimated and forecast capital expenditure; • the level of discretion provided to the economic regulator is considered appropriate; and • the draft rule does not detract from the incentive framework nor encourage gaming behaviour.
<p>Energy Networks Association (ENA)</p>	<p>ENA expressed support for the basis of the rule change request and considered it would improve clarity over the legal basis of decision-making under the NGR and may materially improve transparency and predictability in the operation of the capital base provisions of the NGR.</p> <p>ENA also expressed in-principle support for the alternative rule proposed in the consultation paper, subject to the impact of such a rule being limited to codifying current regulatory practice under the NER. The alternative rule proposed restricting the relevant adjustment to return on capital and making a corresponding rule to the relevant part of the NER.</p>	<p>The Commission notes the ENA's support for the rationale underpinning the rule change request.</p> <p>The Commission has decided not to make a more preferable rule restricting the relevant adjustment to return on capital and therefore no opportunity to make a corresponding rule under the NER arises. See section 4.1.</p>
<p>Economic Regulatory Authority (ERA)</p>	<p>ERA's submission supported the basis for the AER's rule change request, but suggested a different approach to solving the issue identified. The ERA's preferred approach is to provide the economic regulator with the power to</p>	<p>The Commission considers the AER's proposed approach should be preferred over the ERA approach because:</p> <ul style="list-style-type: none"> • any efficiency benefits to be gained by a using a one-off method of

Stakeholder	Issue	AEMC response
	<p>make the relevant adjustment as a one-off cash flow adjustment to the first year in the relevant access arrangement period or, alternatively, apply the adjustment in a present value neutral way across each year in the relevant access arrangement period.</p> <p>ERA argues its approach would allow the economic regulator and service providers to deal with the adjustment as soon as practicable and provide clarity to all parties. In addition, prices would revert to efficient levels faster.</p>	<p>adjustment are outweighed by the potential impacts of price variations where material differences between estimated and actual capital expenditure do occur; and</p> <ul style="list-style-type: none"> adding a new process to the building block approach would create additional administrative burden on service providers and the economic regulators. <p>The draft rule is functional, relatively familiar to service providers and the economic regulators, and simple to apply for both the regulator and the service provider.</p>
Jemena Gas Networks (JGN)	<p>JGN considered the proposed rule change would provide certainty to the NGR and better meet the NGO.</p> <p>JGN also expressed its support for the more preferable rule proposed in the consultation paper, suggesting it would provide clarity to the scope of the relevant adjustment.</p> <p>JGN submitted that the rule change request is non-controversial and that there would be added certainty to service providers preparing currently preparing access arrangement proposals if any final rule were to apply from the date the AEMC published the rule change request.</p>	<p>The Commission notes JGN's support for the rule change request.</p> <p>The Commission has decided not to make a more preferable rule. This is discussed further at section 4.1.</p> <p>If a final rule is made, the Commission will determine the date of application of the rule in accordance with best regulatory practice and compatibility with the national gas objective.</p>