

21 August 2014

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

AEMC reference: GRC0025

Dear Mr Lady

Thank you for the opportunity to respond to the AEMC's draft rule determination in relation to setting the Opening Capital Base under the National Gas Rules (NGR).

APA's earlier submission

APA Group (APA) has previously submitted on this matter, setting out its reasons for not supporting the rule change. APA's earlier submission did not support the proposed Rule change as the Rule change:

- Does not recognise the regulator's current powers under the NGR to assess the prudence of capital expenditure forecasts and estimates;
- Makes an erroneous distinction between estimated and forecast capital expenditure as having different incentive properties;
- Creates incentives for capital expenditure in the estimated year of an access arrangement which are contrary to the general incentives of the scheme to incur lower costs than were estimated/forecast and to delay investment where efficient to do so; and
- Creates the risk that service providers will not be given the opportunity to recover their efficient costs where an unforeseen delay in expenditure shifts estimated expenditure into the forecast period.

APA remains of the view that the Rule change is not consistent with the National Gas Objective, and that the AEMC should not make the Rule as proposed.

AEMC consideration of proposed Rule change

The AEMC's reasoning in the draft Rule determination is effectively that the incentive offered in respect of forecasts of capital expenditure is the appropriate incentive under the regime, and any incentive created through inaccurate estimates of capital expenditure ought to be nullified.¹

While this principle may reflect the AEMC's preferred policy outcome in respect of incentives, the AER's and AEMC's solution does not acknowledge or address the

¹ Australian Energy Market Commission 2014, *National Gas Amendment (Setting the Opening Capital Base) Rule 2014: Draft Rule Determination*, 10 July, pp 13-14

incentives created by the proposed solution: the automatic recovery of a return on investment of actual capital expenditure. This is because both the proposal and the draft Rule determination focus on the incentives relevant to making the *estimate*, rather than the incentives relevant to the ultimate levels of *expenditure*.

APA's earlier submission explained that the regulator has sufficient powers to address and rectify any issues related to incentives for inefficient or unreasonable estimates that may be created by the current interpretation of Rule 77(2). This fact has been acknowledged by the AEMC in its draft Rule determination.²

The AER and AEMC, however, do not address the differing incentives created for expenditure under the current and proposed rules. The draft Rule determination states that the Rule change, if made, would not impact the forecast incentive framework.³ This may be the case; but that does not mean that it will not impact incentives for expenditure that may override the power of the forecast incentive framework in the final year of the period.

APA maintains that it is not reasonable to expect that an automatic and retroactive recovery of returns on all capital spent will not impact incentives to spend capital. The current interpretation of Rule 77(2) does not create this type of conflicting incentive, and instead reinforces the incentives under the forecast capital expenditure framework towards efficient expenditure. On this basis, APA maintains that the current interpretation of Rule 77(2) (that which was affirmed by the Australian Competition Tribunal in 2013) is the preferable formulation of this Rule, and ought to be maintained in the gas access regime.

Regulatory certainty and transparency

Notwithstanding the recent decision by the Australian Competition Tribunal in respect of the interpretation of Rule 77(2), APA recognises that the current situation may create uncertainty as to the future application of Rule 77(2). The interpretation of this Rule has now been subject to two conflicting Tribunal decisions and, while we believe that the most recent Tribunal decision is correct and reflects the intent of the Rules, there is at least some indication that this Rule could be clearer in its future application.

APA considers that these revisions could be considered desirable regardless of the outcome of the AEMC's consideration of the AER's proposed rule change. It is therefore not appropriate for the AEMC to refer to the AER's proposal as improving certainty as a reason to accept the Rule change; an alternative rule change that clarified the operation of Rule 77(2) in line with the most recent Tribunal decision would offer equivalent certainty. The AEMC must instead consider which option best satisfies the National Gas Objective and revenue and pricing principles, and then ensure that the Rules deliver clarity over the application of that approach.

APA considers that the application of the Rule as affirmed by the most recent Australian Competition Tribunal decision best satisfies the National Gas Objective and revenue and pricing principles, and any Rule change made should seek clarity the application of this Rule in line with that decision.

² AEMC 2014, *National Gas Amendment (Setting the Opening Capital Base) Rule 2014: Draft Rule Determination*, p 11

³ AEMC 2014, *National Gas Amendment (Setting the Opening Capital Base) Rule 2014: Draft Rule Determination*, p 6

Scope of adjustment

APA considers that, should the AEMC determine to change the incentives of the scheme in line with the AER's proposal, the scope of the proposed rule needs to be better defined.

It appears that the AEMC intends for the proposed Rule change to give the regulator scope to apply an adjustment under Rule 77(2) in the same form and scope as it has previously. This is evident from the statement that "relevant historical practice provide(s) sufficient clarity and certainty to affected parties as to the intended operation and application of the proposed rule."⁴

The form of the draft Rule change, however, gives the regulator potentially far greater scope for adjustments that APA considers would be contrary to the incentives under the regime in respect of forecasts. APA considers that these potentially broader adjustments would not be consistent with the National Gas Objective or the revenue and pricing principles, and should be excluded from the scope of the adjustment under any revision of Rule 77(2).

The current proposed drafting to "remove any benefit or penalty associated with any difference between the estimated and actual capital expenditure" is very broad, and could extend to the adjustment of decisions that are perceived to be consequent on a difference between estimated and actual expenditure, and that are part of the forecast period (that is, AAP2 in AEMC's figure 3.1). This could extend to adjustments to take account of operating expenditure, demand assumptions, or later capital expenditure that is perceived to be linked to differences in capital expenditure in the estimated year. Such adjustments would be far beyond the scope of adjustments made by the AER in the past (which have been limited to the return on capital associated with the gross difference in estimated and actual capital expenditure values), and would significantly impact the incentive properties of the regime in respect of forecasts.

APA considers that the scope for such adjustments in respect of forecasts should be clearly proscribed. As such, APA considers that the scope of the adjustment, if made, should be limited to impacts on the capital base arising from the difference between the estimated and actual capital expenditure.

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

Yours sincerely



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⁴ AEMC 2014, *National Gas Amendment (Setting the Opening Capital Base) Rule 2014: Draft Rule Determination*, p 16