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Mr John Pierce
Chairman
Australian Energy Market Commission
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Dear Mr Pierce

Submission on Consultation Paper: 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 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 rule change proposal, 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 matter set out in the proposed rule change submission by the AER and the Consultation Paper published by the Australian Energy Market Commission (**AEMC**), and provides the following comments.¹

The issue to be addressed

It is noted that the service provider is generally required to submit an access arrangement in the year prior to its intended start date. As a result, the service provider estimates the capital expenditure required for the year prior to the start date in order to roll forward the capital base. The regulator would assess this estimate in accordance with rules 74 and 79 of the NGR and determine the estimate to be used for the roll-forward of the capital base to calculate reference tariffs. This would generally occur only months before the next access arrangement (n+1) was due to commence.

The actual capital expenditure during the year preceding the start date of the next access arrangement (n+1) may differ from the estimate approved by the regulator for the purpose of rolling forward the 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, then the service provider would either benefit or be penalised over the remaining life of the asset. However, the current NGR (rule 77(2)(a)) does allow the regulator to correct the opening capital base for the following access arrangement period (n+2). As a result, the service provider would either gain or lose

¹ Australian Energy Regulator, *Rule Change Proposal – rule 77(2)(a) of Part 9, Division 4 of the National Gas Rules*, 11 November 2013. Australian Energy Market Commission, *Consultation Paper – National Gas Amendment (Setting the Opening Capital Base) Rule 2014*, 17 April 2014.

during the n+1 access arrangement period without an adjustment for the consequences of the estimation error.

Prior Regulatory Practice

Adjustments for capital expenditure estimation errors in the final year of an access arrangement were adjusted by the AER when applying the NGR. Thus, if actual capital expenditure incurred by a service provider in the final year of an access arrangement was over and above the estimate (following an underestimated forecast for the final year), the capital expenditure still would be subject to the conforming capital expenditure requirements under rule 79.² Provided that the capital expenditure met the requirements under rule 79, an adjustment to the capital base would be made, in addition to allowing the service provider to recoup the requisite return on capital. Service providers would not be penalised for undertaking efficient investment decisions in the final year of the access arrangement, which is consistent with the National Gas Objective (**NGO**).

However, if a service provider overestimated capital expenditure for the final year, this would result in an opening capital base adjustment by the regulator for the difference between the estimate and actual capital expenditure in addition to adjusting for the benefit received from the return on the amount of overestimated capital expenditure. Such an adjustment would ensure that the service provider would be compensated for the actual expenditure and users would be no worse off in future access arrangement periods.

The ERA has not encountered this issue to date as its determinations with respect to the two access arrangements approved pursuant to the NGR were finalised following the commencement date of the new access arrangement period. The actual capital expenditure for the final year of the preceding access arrangement period was known by the time of the final decision.

Tribunal Findings

The rule change proposal notes that the Australian Competition Tribunal's (**Tribunal**) decision on the APA GasNet application highlighted errors with the approach previously adopted by the AER to address the estimation correction adjustments.

In particular, the AEMC consultation paper states the Tribunal's decision on the APA GasNet application determined that the current wording of rule 77(2)(a) "does not empower the AER to adjust the opening capital base with respect to revenue associated with the return on capital and arising out of any difference between estimated and actual capital expenditure in the final year of an access arrangement period".³

The AER's rule change proposal raises the concern that there may 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 benefit to service providers for any overestimate.⁴

Such behaviour would result in users paying higher tariffs during the course of the subsequent access arrangement period. It is noted that the Tribunal in the Jemena decision, stated that

² Australian Competition Tribunal, Application by APA GasNet (Operations) Pty Ltd (No 2) [2013] ACompT8ACT.

³ Application by APA GasNet, 2013.

⁴ AEMC, Consultation Paper, 2014, p. 8. AER, Rule Change Proposal, 2013, p. 10.

it was not the intention of the AEMC and the South Australian Minister to allow service providers to “keep the return on capital of an over-estimation”.⁵ Furthermore, such treatment of the estimation error, would not contribute to the achievement of the NGO.

Accordingly, the ERA agrees with the AER’s view that an amendment to the NGR is likely to better contribute to the achievement of the NGO, especially with respect to promoting efficient investment.⁶

Adjustment for estimation error

Whilst the ERA agrees that a rule change is necessary in order to contribute to the achievement of the NGO, it considers that the NGR should provide for alternative methods to adjust for the estimation error.

Adjustments to the capital base and the building block components are necessary in the n+2 access arrangement period. Such adjustments would need to ensure that the present value of the building block cash flow, after adjustments, is identical to the present value of the building block cash flow had the regulator based its decision on the actual capital expenditure in the last year of the access arrangement period n when setting the n+1 access arrangement tariff revenue.

The AER’s method is understood to be a capital based adjustment, which, for an underestimate, would in effect capitalise the return on capital that the service provider was owed over the previous access arrangement period. However, technically, the return on capital would have been treated as a cash flow item had the estimates been correct in the first instance. The AER method would result in the service provider facing an adjustment for the return on capital over the life of the relevant assets in the regulatory asset base, through multiplying the rate of return by the projected capital base.⁷ This represents a slow and drawn out adjustment for users and service providers.

The ERA’s preferred approach would be to make a one-off cash flow adjustment to the first year in the n+2 access arrangement period or, alternatively, apply the adjustment in a present value neutral way, across all the years in the n+2 access arrangement period. This approach would allow the regulator and service providers to deal with the adjustment as soon as possible and provide 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 be that prices revert to efficient levels faster, providing the right economic signals to customers consistent with the NGO.

It is acknowledged that there could be potential for prices to vary more in the short term as a result of applying an adjustment as a cash flow adjustment over one or all years in the n+2 access arrangement period. However, provided that a service provider complies with rule 74 in forming its estimates, the likelihood of such a large variance occurring would be minimised.⁸

The preferred adjustment method could be implemented as another component of the building block approach under rule 76. This would take the form of an amended rule 76 to allow for the adjustment to be applied as an extra component, (f), and would then be confined to only the n+2 access arrangement period, as per the approach above.⁹ An overestimate or

⁵ Australian Competition Tribunal, *Application by Jemena Gas Networks (NSW) Ltd (No 3)* [2011] A CompT 6.at [54]-[55].

⁶ *National Gas Access (WA) Act 2009*, section. 23.

⁷ *National Gas Rules*, Version 20, rule 76(a).

⁸ *National Gas Rules*, Version 20, rule 74.

⁹ *National Gas Rules*, Version 20, rule 76.

underestimate would be subtracted or added back respectively to the total revenue requirement for the n+2 access arrangement period.

In summary, the ERA agrees with the AER's rationale behind the rule change request but encourages the AEMC to also consider the alternative capital base and cash-flow method adjustment to address this issue.

Yours sincerely



LYNDON ROWE
CHAIRMAN

30/5/14