Australian Gas Infrastructure Group

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Claire Valence
Director – Retail Policy
energycouncil@environment.gov.au

Dear Claire:

Proposed Energy Rule Amendments: Binding rate of return instrument

I am writing in response to the proposed Energy Rule Amendments, released on September 28, which are intended to support the recent introduction of binding rate of return guidelines. This letter provides a brief overview of our main points, and we also support the submission of Energy Networks Australia (ENA) which addresses these concerns in more detail.

Australian Gas Infrastructure Group (AGIG) is one of Australia's largest utility businesses. Our assets are valued at around $9 billion and include gas distribution networks in Queensland, Victoria and South Australia and gas transmission pipelines and gas storage facilities located in most states and territories.

We are looking in this submission to engage positively and highlight some key areas where we consider the draft rules could benefit from additional clarity. We have two points, which both relate to the potential impact which the proposed rules may have on incentive regulation in Australia due to a lack of clarity. This well-established form of regulation which aims to provide an incentive for the continued pursuit of efficiency gains by regulated businesses. In our understanding, there is no debate about the efficacy of this framework, nor desire amongst policymakers to roll it back.

Our first point associated with improving clarity concerns the proposed wording of the substitution for the current Rule 87, and, in particular 87(b), which proposes to adjust the opening capital base within a regulatory period by adjusting for:

> *conforming capital expenditure, depreciation, and the value of pipeline assets disposed of, in the preceding regulatory years of the access arrangement period*

Our point is two-fold:

- The use of the phrases "conforming capital expenditure, depreciation and value of pipeline assets disposed of" are inconsistent with the terms used in Rule 78. The calculation of v_t must take into account 87(b) in the same manner as under Rule 78. But Rule 78 relates to *forecast* capital, *forecast* depreciation etc. Rule 79 deals with conforming capital expenditure and identified the capex, assessed on an ex-poste basis, to be added to the asset base when it is rolled forward from one period to the next. Bringing the term used to describe the process of assessing actual against forecast capital expenditures from one Access Arrangement to the next into a description by which the rate of return building block is determined in-period could cause confusion. At present, the RAB, updated for *forecast* capital expenditure and depreciation (that is, forecast at the start of the relevant Access Arrangement period) is updated year on year through the period, and the WACC is applied to that updated RAB to determine the rate of return building block for that year within the PTRM. However, if the AER is now directed to consider *conforming* capital expenditure, it is not clear what it should do.

- The use of the words “***in the preceding regulatory years of the access arrangement period***” suggests it may be contemplated that the capital base is to be updated for conforming capital expenditure (rather than forecast), actual depreciation, disposals etc *within* the regulatory period. This would substantially increase the burden on the AER, and is likely to increase volatility in pricing as capex timing changes. However, the more pervasive impact would be the removal of the incentive for efficiency in capital spending; if the AER is going to undertake a conforming capital assessment as per Rule 79 every year, then there is no incentive to underspend a forecast. In fact, there is an incentive to over-spend it. This is not in keeping with incentive regulation.

Our second, point relates to the proposed changes to Rule 87A and, in particular, the proposed changes to the definition of ETI_t. The current definition reads:

> *ETI_t is an estimate of the taxable income for that regulatory year that would be earned by a benchmark efficient entity as a result of the provision of reference services if such an entity, rather than the service provider, operated the business of the service provider*;

The proposed definition reads:

> *ETI_t is an estimate of the taxable income of the service provider for the regulatory year as a result of relevant reference services*

The clear difference between the two is that the concept of a benchmark efficient entity is removed. We appreciate there may be reasons for removing the exact phrase, but the legal consequence of the change appears to be to require the AER to consider estimates of the actual taxable income of *the* service provider, and not the estimates of the taxable income of an efficient benchmark firm. Since tax paid is an output of decisions made in respect to operating and other expenditure, this will have a profound effect across the board for incentives to produce efficiency gains that benefit consumers.

Although the proposed rule change has an impact in both gas and electricity, it is arguably more profound in gas because, unlike the relevant proposed clause in electricity, there is no reference to the post-tax revenue model (PTRM) in the proposed rule change for gas. This may be because the AER is not mandated to use the PTRM in gas, whilst it is in electricity. However, the AER does use the PTRM in gas and thus the AER might produce one tax output in its PTRM modelling, and then be forced by this proposed rule change to insert an inconsistent taxable income estimate based upon AGIG’s actual liabilities, as an input to its PTRM model. This is likely to considerably complicate the AER’s task of producing a price cap for our regulated businesses.

There were no explanatory memoranda released with the proposed rule change, so it is not clear what the intent was of the changes in wording outlined above. However, we do not believe that the CoAG Energy Council intend to roll back incentive regulation. Accordingly, we would now urge CoAG to explore the unintended consequences we discuss above, and to reconsider the drafting of the rule change with a view to considering alternate wording which would alleviate the issues we raise. We note and support the wording suggested in the ENA submission in this regard.

If you would like any further clarification on our views, please do not hesitate in contacting either myself or Nick Wills-Johnson on 08 92234902.

Yours sincerely

Craig de Laine
General Manager People and Strategy