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APA submission on rule amendments to give effect to rate of return instrument

APA Group (APA), a major owner and operator of gas transmission pipelines, appreciates the opportunity to comment on amendments to the National Gas Rules (NGR) to implement the binding rate of return instrument now being introduced into the National Gas Law.

Two important amendments are to be given effect through the National Gas (Binding Rate of Return Instrument) Amendment Rule 2018. They are:

- existing rule 87 is to be removed and replaced
- existing rule 87A is to be removed and replaced by a new rule 87A in which the definition of estimated taxable income (ETI_t) has been changed.

For the reasons set out below, APA is of the view that:

- new rule 87 should be amended to require that v_t , the projected capital base at the beginning of year t , utilise the calculation already undertaken under rule 78
- the amendment of the definition of ETI_t in new rule 87A is not necessary for implementation of the binding rate of return instrument and should not be made.

New rule 87

New rule 87 defines a value $RPCB_t$, which is the return on the projected capital base at the beginning of regulatory year t . That return is required for determination of the total revenue in accordance with rule 76. The total revenue is, in turn, required for reference tariff determination in accordance with rules 94 and 95.

In the scheme of Part 9 (rules 69 – 99), total revenue and reference tariff determination are for a forthcoming access arrangement period; they are “forward-looking”. For $RPCB_t$ to be the required return, the value v_t used in the calculation of $RPCB_t$ must be the value of the projected capital base at the beginning of each year t of the forthcoming access arrangement period.

Rule 78 sets out the way in which the projected capital base – the capital base for the forthcoming access arrangement period – should be calculated. The projected capital base for a particular period is to be the opening capital (the capital base at the commencement of that period), plus forecast conforming capital expenditure for the period, less forecast depreciation and the forecast value of any asset disposals.

This calculation of the projected capital base, and the calculation of the return on the projected capital base required for total revenue and reference tariff determination, are carried out in the Australian Energy Regulator's Post-Tax Revenue Model. Use of the Post-Tax Revenue Model by regulated gas pipeline service providers is expected to become mandatory once proposed changes to the NGR, which the Energy Council submitted to the Australian Energy Market Commission on 5 October 2018, are implemented.

New rule 87 should require that v_t be the projected capital base in year t calculated in the way required by rule 78.

v_t should not be calculated taking into account the factors (a) to (c) of new rule 87.

Factor (b) of new rule 87 is inconsistent with the forward-looking determination of total revenue and reference tariffs under Part 9 of the NGR. Conforming capital expenditure, depreciation, and the value of asset disposals are not known at the time of total revenue and reference tariff determination. What are known at that time, and what must be used in the calculation of the projected capital base, are forecasts of conforming capital expenditure, depreciation, and the value of asset disposals. These are the forecasts required by rule 78.

Inclusion of the definition of $RPCB_t$ in new rule 87 makes explicit the way in which the rate of return is to be applied within the scheme of price and revenue regulation of Part 9 of the NGR. To ensure that total revenue and reference tariff determination continue to give effect to that scheme, v_t should be defined as the value of the projected capital base at the beginning of regulatory year t , calculated in way required by rule 78. There is no additional requirement to "take into account" the factors (a) to (c) of new rule 87. To do so would lead to error in the total revenue, and to error in the reference tariffs determined from that total revenue.

New rule 87A

Current rule 87A defines ETI_t as the estimate of taxable income in regulatory year t which would be earned by a benchmark efficient entity from the provision of reference services if such an entity, rather than the service provider, operated the business of the service provider.

Setting aside debate over the way in which the factor γ (gamma) is to be estimated, the application of this rule in post-tax revenue modelling has not been contentious for well over a decade.

The definition of ETI_t in current rule 87A serves to ensure that the total revenue calculation uses the correct estimate of the cost of tax (ETC_t). That correct estimate is the estimate of the cost of tax which leads to an efficient level of total revenue, and to efficient reference tariffs. It is the estimate of the cost of tax obtained (via the equation in rule 87A) from an estimate of the taxable income of an efficient entity providing reference services. The correct estimate of the cost of tax is not obtained from the taxable income of the service provider, which may have been calculated from inefficient revenues from, and inefficient costs of, reference service provision.

ETI_t should not be defined, as is now proposed in new rule 87A, as the estimate of the taxable income of the service provider in regulatory year t as a result of relevant reference services. Amending the definition of ETI_t in this way will not, on its own, lead to the correct estimate of the cost of tax, or to the efficient level of total revenue and to the efficient reference tariffs required by the scheme of Part 9 of the NGR.

The change in the definition of ETI_t in new 87A is, on its own, seriously incomplete, with unexamined consequences for total revenue and reference tariff determination. It is not necessary for the implementation of the binding rate of return instrument.

At issue here is the way in which tax is to be treated in the application of the regulatory regime of the NGR. This is a matter currently being reviewed by the Australian Energy Regulator. Amendment of the definition of ETI_t in new 87A, in advance of completion of the Australian Energy Regulator's review would be, in APA's view, premature. The change in new rule 87A should not be made.

APA notes, as a minor issue of drafting, that new rule 87A continues to use, in the equation describing the calculation of the estimated cost of corporate income tax, the symbol r_t . r_t denotes the expected statutory income tax rate in year t . However, that symbol is now to be introduced into new rule 87, where it is to represent the rate of return in year t . We think that different symbols should be used for the rate of return and the statutory tax rate.

APA would be pleased to elaborate on the views in this submission.



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