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Dear Mr Pierce

Submission on cross period revenue smoothing (Gas) rule change

The Australian Energy Regulator (AER) welcomes the opportunity to comment on the revenue smoothing rule change request made by Jemena Gas Networks (JGN).

As we have not yet remade our *2015 access arrangement decision* for JGN, there is a degree of uncertainty over what the final impact of this will be on gas distribution reference tariffs.[1] It is possible this may lead to a significant difference between JGN's allowed revenue under the remade decision and the actual revenue JGN will recover over the *2015–20 access arrangement period*. We therefore support the aim of the rule change request to reduce the price/revenue volatility that may arise from the outcome of the remittal process. We also agree with enabling smoothing of these price/revenue adjustments over two access arrangement periods, as it would provide greater scope to achieve the aim of minimising price volatility.

We largely support the drafting of the proposed rule. We consider the simple, clear and principles-based drafting style adopted by JGN would enable the AER, JGN and other stakeholders to facilitate the aim of minimising price volatility. At the same time, it provides flexibility to deal with unforeseen factors that may arise out of the remittal and/or revenue smoothing process.[2] We commend JGN on the principles-based approach to rule drafting.

We consider, however, the proposed rule change would benefit from two amendments:

- The rule should explicitly state a "revenue recovery principle". That is, JGN is able to recover only the revenue to which it is entitled and should not receive any windfall gains or losses from the revenue smoothing process. We proposed a similar amendment, which was adopted by the AEMC, to the electricity revenue smoothing rule change proposed by NSW and ACT electricity distributors.
- The end date for making an adjustment determination should be amended to provide flexibility in case of unforeseen delays to the remittal and/or revenue smoothing processes.

[1] Italicised text in this submission adopt the meaning in clause (8) (Definitions) of JGN's proposed rule. JGN, *Rule change proposal - National Gas Rules: Cross period price smoothing for Jemena Gas Networks*, 14 December 2017, Attachment A.
[2] JGN, *Rule change proposal - National Gas Rules: Cross period price smoothing for Jemena Gas Networks*, 14 December 2017, Attachment A.

We discuss these suggested amendments more fully in attachment 1 to this submission. Attachment 2 contains our responses to the AEMC's questions in the consultation paper.

I should also note the process has benefited significantly from the collaborative approach by staff from the AER, AEMC and JGN in developing this proposal. We would also be pleased to provide any further assistance to the AEMC, as appropriate.

Lastly, we note the rule change request provided extensive analysis on the potential price/revenue paths under various scenarios. We note those potential price/revenue paths are useful for illustrative purposes. We will determine the appropriate price/revenue path during the revenue smoothing process under the AEMC's final rule, in conjunction with the remittal process for JGN.

Yours sincerely

Chris Pattas
General Manager
Networks Pricing, Policy and Compliance

Attachment 1

We support the aim of the rule change request to reduce the price/revenue volatility that may arise from the outcome of the remittal process. In general, we also support the drafting of the proposed rule. We consider the simple, clear and principles-based drafting style adopted by JGN would enable the AER, JGN and other stakeholders to facilitate the aim of minimising price volatility. At the same time, it provides flexibility to deal with unforeseen factors that may arise out of the remittal and/or revenue smoothing process

However, we also consider some further amendments would improve the way this smoothing process can work. Below, we discuss the two amendments we consider the AEMC should incorporate into the proposed rule:

- The addition of a revenue recovery principle.
- The amendment to the end date for making an adjustment determination.

Addition of a revenue recovery principle

As with the revenue smoothing participant derogations for the NSW/ACT distribution network service providers (NSW/ACT DNSPs), we consider the proposed rule should include a provision that explicitly states the revenue recovery principle.[3] We suggest this principle be phrased as follows:[4]

> **revenue recovery principle**, in respect of JGN, means the principle that JGN must be given the ability to recover the same, but no more, revenue (in net present value equivalent terms) as it would have recovered if the *remade 2015 access arrangement decision* had been in force from the commencement of the *2015 access arrangement period*, and any control mechanisms specified in the *remade 2015 access arrangement decision* had been implemented in each relevant regulatory year.

JGN's rule change request and proposed rule identify the core problem (potential price shocks due to the appeals process and revenue recovery within the *2015 access arrangement period* only), and suggest a solution (smoothing of revenue across access arrangement periods).[5]

In order to ensure that the proposed solution works as intended, we consider it is essential that JGN recovers only the revenues it is entitled to recover. We raised this issue in the AEMC's consultation process for the NSW/ACT DNSPs' participant derogation, and the AEMC subsequently incorporated a revenue recovery principle in the final rule. The AEMC included the principle to make it clear that the AER had the ability under the final rule to make any necessary variations to the calculation of the revenue adjustments to allow the relevant NSW/ACT DNSP to recover revenue it would have been entitled to recover during the current regulatory control period under the remade determination.[6]

JGN's proposed rule contains provisions that explicitly allow any price/revenue shocks due to the remittal process to be smoothed across access arrangement periods. However, the proposed rule does not include any provisions that reflect the revenue recovery principle. While the proposed rule

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[3] See AEMC, *Participant derogation - NSW DNSPs Revenue Smoothing* (https://www.aemc.gov.au/rule-changes/participant-derogation-nsw-dnsps-revenue-smoothing); AEMC, *Participant derogation - ACT DNSP Revenue Smoothing* (https://www.aemc.gov.au/rule-changes/participant-derogation-act-dnsp-revenue-smoothing).
[4] The final rules for the NSW/ACT DNSPs' participant derogations adopted similar wording for the revenue recovery principle.
[5] JGN, *Rule change proposal - National Gas Rules: Cross period price smoothing for Jemena Gas Networks*, 14 December 2017, p. 1.
[6] AEMC, Rule Determination, National Electricity Amendment (Participant derogation – NSW DNSPs revenue smoothing), 1 August 2017 page 15.

may be interpreted to enable JGN to recover only the revenue to which it is entitled, for the avoidance of doubt, we consider the final rule should include a provision that explicitly reflects the revenue recovery principle. Such a provision would guide the process for determining price/revenue amounts to be smoothed across access arrangement periods, including any disputes arising during that process.

In addition, this provision should enable us to ensure JGN faces the intended properties of its control mechanism when determining this revenue 'entitlement'. JGN operates under a weighted average price cap (or tariff basket) control mechanism. Under a weighted average price cap, JGN sets prices based on a formula which uses X factors based on building block revenues and forecast volumes. Where actual volumes across the access arrangement period varies from the forecast volumes in the access arrangement, JGN's actual revenue will likewise vary from the forecast revenue in the AER's final decision. Therefore, JGN bears the volume risk (positive and negative) over the access arrangement period.[7] We consider the final rule should preserve the volume risk inherent in JGN's control mechanism and that this can be achieved through the inclusion of a revenue recovery principle.

In other words, the net effect of the final rule should be to put JGN in the same position it would have been in had the *remade 2015 access arrangement determination* been in place from the commencement of the *2015 access arrangement period*. The forecast energy throughput as at 2015 should be used to set JGN's remade X factors, and be used in the iterative (retrospective) annual updates in accordance with the control mechanism. Where actual energy throughput is higher than (or lower than) forecast, JGN's revenue entitlement should reflect the increase (or decrease) in line with the difference in energy volumes.

<u>Amendment to end date for making an *adjustment determination*</u>

Clause (2)(b) of the proposed rule states that the AER may only make an *adjustment determination* by no later than 1 March 2019. We understand this timeframe coincides with the time at which JGN would be submitting its annual tariff variation notice for 2019–20 (the final regulatory year of the *2015 access arrangement period*) and as such would enable JGN to incorporate the *adjustment determination* into reference tariffs for the 2019–20 regulatory year.

At this stage, we expect to complete the *remade 2015 access arrangement decision* as well as the *adjustment determination* by 1 March 2019. However, we propose amending clause (2)(b) of the proposed rule to provide for greater flexibility, should unforeseen circumstances delay completion of either the *remade 2015 access arrangement decision* or the *adjustment determination*.

We suggest extending the end date for making an adjustment determination to some point in the next access arrangement period, similarly to what was done for the NSW/ACT participant derogations. Alternatively, the AEMC may consider keeping the suggested timeframes, but provide flexibility in case of unexpected delays to either the *remade 2015 access arrangement decision* or the *adjustment determination*. For example, the AEMC may add the following provision, or similar, to clause (2) of the proposed rule: [8]

> The AER may extend the time within which it is required to publish its *adjustment determination* if:
>
> (1) the *adjustment determination* involves issues of unusual complexity or difficulty; or

[7] If volumes are higher than forecast, JGN earns more than the notional allowed revenue determined under the building block approach. If volumes are lower than forecast, JGN earns less than the notional allowed revenue.
[8] This is similar to clause 6.16(g) in the distribution consultation procedures in part G of chapter 6 of the National Electricity Rules.

(2) the extension of time has become necessary because of circumstances beyond the AER's control.

These suggested amendments should provide sufficient time to achieve the aim of minimising price/revenue volatility even if there is some unexpected delay to the remittal and/or *adjustment determination* process. The final rule can then include high-level principles that enables the AER, in consultation with stakeholders, to determine the appropriate mechanism to minimise price volatility if we make the *adjustment determination* after 1 March 2019.

Attachment 2

Question 1 Long term interest of consumers

(a) To what extent would significant pricing volatility impact consumers and lead to inefficient usage or investment decisions by consumers?

(b) Would allowing the timing of the recovery of revenue to be spread over two access arrangement periods lead to more efficient usage and investment decisions by consumers?

Regarding question 1(a), we consider significant price volatility, even if they are one-off, can lead customers to incorrectly assume they will continue into the future. Customers may then make inefficient investment decisions based on these assumptions. We therefore support a mechanism that avoids long-term inefficient outcomes for consumers by minimising price/revenue fluctuations.

We note the regulatory framework generally attempts to minimise price fluctuations. This is evident in:

- the application of rebalancing side constraints for each reference tariff.[9]
- revenue smoothing through the X factor. The AER uses the X factor to ensure a smoother price/revenue path over an access arrangement period.

Regarding question 1(b), the *adjustment determination* must balance:

- any price shocks from recovering any revenue increments only in the final year of the *2015 access arrangement period*
- deviating from the efficient price/revenue path as determined in the access arrangement decision for the subsequent (2020–25) access arrangement period.

We consider having the option to spread revenue across two access arrangement periods would provide greater scope to achieve the aims of minimising price/revenue volatility arising out of the remittal process, while ensuring JGN recovers only the revenue to which it is entitled.

Question 2 Adjustment mechanism

Does JGN's proposed rule provide the appropriate mechanism to enable the timing of revenue recovery to be spread across two access arrangement periods? What is the appropriate degree of detail and prescription for a mechanism to manage revenue volatility under uncertain circumstances?

The degree of detail and prescription should seek the appropriate balance between:

- certainty of process for the AER, JGN and other stakeholders
- flexibility to deal with factors not accounted for in the proposed derogations.

Subject to the addition of the revenue recovery principle and extension of the end date for making an *adjustment determination*, we support the drafting of the proposed rule. We consider the simple, clear and principles-based drafting style of the proposed rule would enable the AER, JGN and other

[9] JGN, *Access arrangement: JGN's NSW gas distribution networks 1 July 2015 – 30 June 2020 [June 2015] (Incorporating revisions required by AER Final Decision 3 June 2015)*, June 2015, p. 5.

stakeholders to facilitate the aim of minimising price volatility. At the same time, it provides flexibility to deal with unforeseen factors arising out of the remittal and/or revenue smoothing process.