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Via online submission

Mr John Pierce
Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Pierce

Jemena submission to consultation paper—Cross period revenue smoothing – GRC0043

Jemena Gas Networks (NSW) Ltd (**JGN**) is the owner and operator of the NSW Gas Network and is the proponent of GRC0043. JGN proposed the rule change to lessen the significant year-on-year network price volatility our customers would face as a result of the process for finalising our current access arrangement period (2015-20) allowed revenues.

We consider it is in customers' long term interests to make a new rule within the National Gas Rules that would enable the AER the discretion to smooth our revenue between our 2015-20 and 2020-25 access arrangement periods. By doing so, we consider this would eliminate the network price volatility for our customers.

Our submission focuses on three areas:

- An update on the progress of 2018-19 tariffs, for the year beginning 1 July 2018[1]
- Response to AEMC questions
- Comment on the JGN smoothed revenue graphs in the consultation paper.

Update on 2018-19 tariffs

As was the case for implementing tariffs on 1 July 2016 and 1 July 2017, JGN and the Australian Energy Regulator (**AER**) will enter into an Enforceable Undertaking (**EU**) to agree JGN's 2018-19 prices (beginning 1 July 2018—the fourth year of our current access arrangement period). JGN and AER staff discussions have advanced such that JGN is seeking a 5.4% real price decrease.[2]

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1 The 2018-19 year from 1 July 2018 to 30 Jun 2019 may sometimes be referred to as RY19 (the 2019 regulatory year).

2 The 5.4% decrease applies to JGN's tariff basket. Under the weighted average price cap control mechanism, individual tariffs may change more or less than 5.4% so long as the weighted average price cap and our side constraints are not exceeded. The AER checks this as part of the Enforceable Undertaking process.

While JGN is not seeking to pre-empt an AEMC decision on cross period smoothing, or the AER's remade decision, this is consistent with analysis in our rule change request for scenario 3—the AER final decision allowance with cross period smoothing given effect. [3]

The AER has published an open letter on JGN's proposed price change on its website.[4] The AER will balance objectives of revenue/price stability, predictability and transparency when determining whether to accept our EU.

Any decision on 2018-19 tariffs will necessarily impact the rule change vs no rule change analysis we provided with our proposal. This is because, without cross period smoothing, the correction required by the remade decision will subsequently only be able to occur in the final year of our current access arrangement period (2019-20). Our analysis provided with our rule change request assumed the correction could occur over the final 2 years of our current access arrangement period. This assumption no longer holds. Once the 2018 EU is implemented, only one year of the current access arrangement period is left.

Table 1 in Appendix A shows the original and updated X-factor analysis.[5] Table 2 provides updated analysis of gap to cost of service.

Table 2 shows that the required X-factor changes (and therefore volatility) will increase without cross period smoothing—under a AER final decision scenario (Scenario 1), real prices would need to decrease by 38.3% in 2019-20 (39% below cost of service as shown in Table 2) and then increase by 49.9% in 2020-21 (still 9% below cost of service as shown in Table 2). Under this scenario, the X-factor price path would enable JGN to return to within 2.5% of cost of service by 2025.

This network price volatility would not occur with cross period smoothing, which would instead result in 5.3% real decreases in both 2019-20 and 2020-21 under the AER final decision scenario.

Response to AEMC questions

Q1 – Long term interests of customers

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

JGN considers it is not just pricing volatility *per se* that causes inefficient usage or investment decisions. It is the fact that the volatility is not related to actual year on year changes in our costs.

Where prices are not based on cost (and are significantly below cost) it could distort customers decisions to invest in new long life gas appliances or develop usage patterns (habits) that become more difficult to sustain in future years.

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3 JGN rule change request - National Gas Rules, Cross period price smoothing for Jemena Gas Networks, Table B1-1.

4 https://www.aer.gov.au/system/files/AER%20-%20Open%20letter%20-%20Gas%20network%20charges%20JGN%20%28NSW%29%20from%201%20July%202018.PDF

5 JGN has updated the analysis by assuming 2018-19 has a 5.4% real price decrease. All other inputs have been held constant between the original and updated analysis.

Without smoothing, a large divergence occurs between our forecast smoothed revenues (which must be lower due to the necessary price decrease) and our cost to service in 2019-20.[6] Ensuring a return to cost of service by the end of 2025 is the primary driver for the estimated 49.9% price increase that would be required in 2020-21 (without smoothing).

Analysis provided with our rule change request shows that the gap to cost of service in 2019-20 could be as high as 27%[7] without smoothing under the AER final decision scenario. However, as noted above, this was when there were 2 years of the current period to accommodate the AER's remade decision. With a 5.4% real decrease in 2018-19, the gap to cost of service in 2019-20 increases to up to 39% without smoothing under the AER final decision scenario (refer Table 2).

JGN recognises that the AER and businesses may tolerate some difference between annual revenue and the annual cost of service within an access arrangement period, provided this is closed by the end of the period. However, we don't consider it was envisaged to be of the degree potentially facing our customers. JGN notes that minimising the difference between cost of service and final year forecast revenues is deemed desirable in the National Electricity Rules (6.5.9(2)) and is often applied in practice by the AER for gas distributors.

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?

Yes. Our original analysis provided with the rule change request shows that expected revenue and cost of service align closer over the period between 2019-20 and 2020-21. This analysis showed that expected revenue would be a maximum of 12% below cost of service in the scenarios with cross period smoothing, occurring in 2020-21.[8] This does not change when updating our analysis for the 5.4% real decrease in 2018-19. However, as noted above, without cross period smoothing, expected revenue would be 39% below JGN's cost of service in 2019-20.

This means prices would better reflect our costs over this period with cross period revenue smoothing—ensuring more efficient investment and usage decisions by our customers.

Q2 – 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 certain circumstances?

JGN designed our solution to be consistent with the AEMC final decision for NSW networks. This provides the AER discretion to first, decide whether to allow cross period smoothing and second, to determine the adjustment amount that minimises as far as reasonably practical variations across the AA periods.

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6 We use our final year building block costs under the AER final decision as a proxy for cost of service. This value doesn't change whether we assume cross period smoothing or not. 2019-20 is RY20.

7 JGN rule change request - National Gas Rules, Cross period price smoothing for Jemena Gas Networks, Table B1-1.

8 JGN rule change request - National Gas Rules, Cross period price smoothing for Jemena Gas Networks, Table B1-1.

Our proposal includes that adjustments must be NPV neutral – a condition to ensure JGN is no better or worse off as a result of cross period revenue smoothing. This allows the AER to determine an adjustment amount that best meets the long term interests of consumers.

Should the AEMC opt for a more preferable rule, JGN encourages the AEMC to ensure this remains consistent with the weighted average price cap form of price control that has applied to JGN during the current access arrangement period.

Clarification on figures 3.1 and 3.2 of the consultation paper

We note that the AEMC has demonstrated the potential price volatility graphically in the consultation paper by representation of the smoothed revenues from JGN's modelling exercise.[9]

For the avoidance of doubt, these smoothed revenues do not present a forecast of JGN's revenue requirements for the purposes of our 2020-25 access arrangement proposal due for submission to the AER in June 2019. The modelling for this rule change request made some necessary simplifying assumptions of the operating and capital expenditure and cost of capital required in the 2020-2025 period.[10]

We also note that price volatility is the issue faced by customers—given prices depend on the forecast demand levels, a change in smoothed revenue will not necessarily require an equivalent percentage change in price. To best understand the issue this rule change seeks to address, external stakeholders would be best served by both price and revenue impact analysis.

If you have any questions or would like to discuss any aspect of this proposal, please contact Chris Stewart on (02) 9867 7290 or at christopher.stewart@jemena.com.au.

Yours sincerely

Alex McPherson
General Manager Regulation (Acting)
Jemena Limited

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9 AEMC Consultation paper, Figures 3.1 and 3.2.

10 JGN assumed an average of the 2015-16 to 2019-20 AER final decision allowances for 2020-21 to 2024-25. Operating expenditure for the 2020-2025 period is assumed to be equal to the 2019-20 allowance, as set out in the AER's (original) decision for the 2015-2020 period. The cost of capital for the remainder of the current period and throughout the 2020-2025 period is assumed to be the same as for 2017-18.

Appendix A - Updated analysis

Table 1. X-factors (positive X factor is a real price decrease)

2018-19 updated for 5.4% real decrease?	Regulatory Years	Units	RY16	RY17	RY18	RY19	RY20	RY21	RY22	RY23	RY24	RY25
No Cross period smoothing with return to cost of service to within 3%												
No	Scenario 1: AER final decision, no cross-period smoothing	%	20.4%	2.5%	7.0%	16.5%	**16.5%**	**-25.8%**	-8.6%	-2.9%	-1.0%	-0.3%
Yes	*Scenario 1: AER final decision, no cross-period smoothing*	*%*	*20.4%*	*2.5%*	*7.0%*	*5.4%*	***38.3%***	***-49.9%***	*-10.0%*	*-2.0%*	*-0.4%*	*-0.1%*
No	Scenario 4: Amodified AER final decision, no cross period smoothing	%	20.4%	2.5%	7.0%	8.4%	**8.4%**	**-14.0%**	-4.7%	-1.6%	-0.5%	-0.2%
Yes	*Scenario 4: Amodified AER final decision, no cross period smoothing*	*%*	*20.4%*	*2.5%*	*7.0%*	*5.4%*	***14.7%***	***-17.2%***	*-5.7%*	*-1.9%*	*-0.6%*	*-0.2%*
Cross period smoothing with return to cost of service to within 3%												
No	Scenario 3: AER final decision with cross period smoothing	%	20.4%	2.5%	7.0%	5.4%	**5.4%**	**5.4%**	-2.5%	-2.5%	-2.5%	-2.5%
Yes	*Scenario 3: AER final decision with cross period smoothing*	*%*	*20.4%*	*2.5%*	*7.0%*	*5.4%*	***5.3%***	***5.3%***	*-2.5%*	*-2.5%*	*-2.5%*	*-2.5%*
No	Scenario 6: Modified AER final decision with cross period smoothing	%	20.4%	2.5%	7.0%	2.2%	**2.2%**	**2.2%**	-1.5%	-1.5%	-1.5%	-1.5%
Yes	*Scenario 6: Modified AER final decision with cross period smoothing*	*%*	*20.4%*	*2.5%*	*7.0%*	*5.4%*	***-0.7%***	***-0.7%***	*-0.7%*	*-0.7%*	*-0.7%*	*-0.7%*

Table 2. Cost of service and forecast (smoothed) revenue (updated for 5.4% real decrease in 2018-19)

Regulatory Years	Units	RY16	RY17	RY18	RY19	RY20	RY21	RY22	RY23	RY24	RY25
No Cross period smoothing with return to cost of service to within 3%											
Scenario 1: AER final decision, no cross-period smoothing											
Cost of service (building block costs)	$M nominal	398.8	428.9	458.7	487.6	478.7	498.0	525.6	519.4	546.5	573.3
Smoothed revenue	$M nominal	494.2	496.8	474.0	460.4	292.4	453.8	516.7	545.6	567.1	587.6
Gap to cost of service	%	24%	16%	3%	-6%	-39%	-9%	-2%	5%	4%	2%
Scenario 4: Amodified AER final decision, no cross period smoothing											
Cost of service (building block costs)	$M nominal	415.5	448.3	480.7	510.3	502.0	522.0	550.4	544.9	572.9	600.6
Smoothed revenue	$M nominal	494.2	496.8	474.0	460.4	404.5	490.8	537.2	566.8	590.5	612.6
Gap to cost of service	%	19%	11%	-1%	-10%	-19%	-6%	-2%	4%	3%	2%
No Cross period smoothing with return to cost of service to within 3%											
Scenario 3: AER final decision with cross period smoothing											
Cost of service (building block costs)	$M nominal	398.8	428.9	458.7	487.6	478.7	498.0	525.6	519.4	546.5	573.3
Smoothed revenue	$M nominal	494.2	496.8	474.0	460.4	448.9	440.0	466.9	495.5	525.7	557.9
Gap to cost of service	%	24%	16%	3%	-6%	-6%	-12%	-11%	-5%	-4%	-3%
Scenario 6: Modified AER final decision with cross period smoothing											
Cost of service (building block costs)	$M nominal	415.5	448.3	480.7	510.3	502.0	522.0	550.4	544.9	572.9	600.6
Smoothed revenue	$M nominal	494.2	496.8	474.0	460.4	477.4	497.5	518.5	540.4	563.2	587.0
Gap to cost of service	%	19%	11%	-1%	-10%	-5%	-5%	-6%	-1%	-2%	-2%