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21 August 2014

Mr John Pierce
Chairman
Australian Energy Market Commission
PO BoxA2449
Sydney South NSW 1235

Dear Mr Pierce,

GRC0025: National Gas Amendment (Setting the Opening Capital Base) Rule 2014

Thank you for the opportunity to comment on the Commission's recent draft rule change on the above issue. This letter provides a brief response to a number of key points in that draft rule change.

Incentive properties of estimates

The Commission suggests that estimates and forecasts are different due to their different definition in the NGR, and that estimates of capital expenditure are not intended to form part of the incentive mechanism. DBP agrees that the NGR defines forecasts and estimates differently, and this does appear to show an intent in energy policy that estimates not form part of the incentive framework. It is, however, incorrect to conclude, that the AER's proposed rule change would remove the incentive properties of estimates.

The automatic recovery of a return on investment of actual capital expenditure can be reasonably expected to create an incentive in respect of expenditure in the final year of the access arrangement period and the different treatment of estimates and forecasts (which are both assessments made under conditions of uncertainty) distorts investment incentives. DBP acknowledges that the likely impact of this incentive may be minor due to the timing of estimates (close to the end of the final regulatory year) and the degree of regulatory oversight of expenditure, but this is not a reason to create distortions in investment incentives if alternative options are available.

As there is no 'incentive free' option available for the treatment of estimates, DBP believes that the Commission's consideration of this matter should centre on which option imposes the least distortionary impact on the underlying incentive properties of the framework. DBP considers, as set out in the previous APIA submission, that the current treatment of estimates under the Rules (that recently confirmed by the Australian Competition Tribunal) achieves this outcome, as under this approach the incentives provided by estimates in the final year of the access arrangement period operate in the same direction as those provide by forecasts – that is, to incur lower costs than were estimated/forecast and to delay investment where it is efficient to do so. By contrast, the AER's proposal (as accepted by the Commission) appears to provide an incentive not to constrain costs in the final year of the access arrangement period compared to estimates, as any over-spend is later rewarded, with interest.

With the apparent policy goal of attempting to minimise the extent to which the estimates are drawn into the incentive framework, we discuss an alternate true-up mechanism that achieves the same outcome as that proposed by the AER, but with fewer distortions. First, however, we discuss a key aspect of regulator behaviour (or perceptions thereof) which has been ignored in the debate to date, and which has an important influence on investment incentives.

Intended scope of adjustment

Incentive-based regulation is intended to provide incentives for service providers to reduce costs over time by allowing them to keep cost savings for a period of time. However, a well-designed system also encourages regulators to send the right signals to investors. At present, if a service provider makes an investment which appeared to be prudent at the time the investment decision was made (and was perceived as such by the regulator), but which subsequently transpired to be unviable, say due to falling demand, then regulators can remove the asset from the regulatory asset base once new relevant information comes to hand to prevent service providers from earning a future return on assets which the market no longer needs.[1]

However, the proposed rule change opens the door to a different kind of signal, given that the scope of the "benefits and penalties" clause is very wide, and that the true-up between estimates and actual expenditure is retroactive and happens at the same time as the assessment of the prudency of capital spending that entered the previous access arrangement as either a forecast or an estimate. That signal pertains to the likelihood of retroactive assessment of and correction for past decision which use evidence that is only available with the benefit of hindsight.

We accept that the intent of the rule change is to do simple things such as true-up a $5 million difference between actual and estimated capital spend and adjust this for rates of return. However, the scope of the rule change allows regulators to also assess qualitative differences between estimated and actual capital expenditure (that is, not just the dollar amounts, but instead the projects undertaken and their relevant costs) and to take account of benefits and/or penalties it perceives may have occurred as a result of these qualitative differences like, for example, differences in subsequent investment or the provision of different services.

This has the potential to 'open-up' expenditure in the forecast period (AAP2 in the Commission's Figure 3.1) that is perceived to be linked to a deviation between estimated and actual expenditure, and undermine the incentive properties of the regime that allows the service provider to retain for a period any efficiencies achieved against forecast expenditure.

We note that this has not yet occurred in electricity which has had a benefits and penalties clause for some time.[2] However, the very first time it does occur, the signal to investors will be very different; investors will realise that returns which all parties (regulators included) believed were prudent and appropriate when the investment was planned can be retroactively taken away from them if future information reveals that demand patterns were not as forecast. Even before it occurs, investors will be considering the likelihood of such retroactive assessments. This retroactivity does not exist in any other market; indeed there is no way it can occur in competitive markets where there is no regulator to apply it.

In line with the discussion above, we appreciate the need to employ some kind of true-up mechanism, but the risks associated with the mechanism proposed by the AER are too great, and the consequences of adverse application of the rule too pernicious for this mechanism to be used.

We consider that two adjustments to the approach in the Commission's draft decision should be made to address this issue:

- That the scope of adjustments be more clearly defined, and confined to direct impacts on the RAB arising from the difference between the estimated and actual capital expenditure; and
- That the mechanism for adjustment apply closer to the time that actual capital expenditure information is known for the final year of AAP1.

We discuss each of these changes to the draft Rule in the remaining section.

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[1] Before doing so, the regulator must consider the uncertainty that this approach would cause (Rule 85). In particular, DBP considers that this approach leads to a real risk that service providers are not able to recover their efficient costs because of a downside truncation of returns that is not balanced against an equivalent opportunity to earn upside returns due to price regulation. Nevertheless, the gas access regime contemplates this type of forward looking signal to the service providers in respect of redundant assets as being appropriate in some circumstances.

[2] Though we note that electricity did not, until recently, have the mechanism to re-assess the prudency of forecast capital spend prior to it becoming part of the regulated asset base that gas has long had.

Preferred form of adjustment

Limiting the scope of adjustment

As discussed in the previous section, we believe that the scope of the proposed rule could be wider than that intended by the Commission, and that the application of the rule with the wider scope would undermine the intended incentive properties of the regime.

In this regard, DBP does not agree with the statement in the Commission draft determination that the wording of the proposed rule and relevant historical practice provide sufficient clarity to affected parties as to the intended operation of this rule.[3] On the contrary, DBP considers that the wording of the proposed rule is unnecessarily broad so as to create uncertainty and ambiguity as to the powers of the regulator and the operation of the incentive regime.

DBP considers that the scope of the adjustment should be limited to impacts on the RAB arising from the difference between the estimated and actual capital expenditure.[4]

This coincides with the AER's past practice, and ensures that the adjustment does not extend into adjustments to forecast expenditure in AAP2 in the ways described above. As it appears that the Commission intends that the adjustment operate in this way, this intent should be codified in the Rules.

Timing of adjustment

We appreciate that this issue with estimates would not exist in a simplistic, perfect world, where regulators made a decision on day *t*, based on costs incurred up to day *t-1*, for pricing periods that commence on day *t+1*. In such a world, there is no issue with estimates, as only actual data are used. This leads us to accept the Commission's expressed desire that estimates form no part of the incentive framework, notwithstanding the fact that they always will to some extent. The question then becomes how to minimise the degree to which incentives are distorted by a true-up mechanism between estimated and actual capital expenditure.

In principle, it does not matter when the true-up occurs, provided rates of return are taken into consideration, because all true-ups will lead to the same outcome in NPV terms. This basic principle may be why the AER has proposed grafting the true-up onto an existing check of the prudency of past capital spending going into a future access arrangement in the way that it has.

However, two practical issues arise. Firstly, regardless of NPV neutrality, the longer one waits for the true-up, the greater are the amounts of money involved, and thus the greater risk that tariffs applying in the interim are inefficient as they are either set too high or too low. Secondly, and perhaps more importantly, the longer the delay, the greater the likelihood that a regulator will (particularly if the Commission does not accept the suggestion above to limit the scope of the adjustment to the direct impacts on the RAB), at some stage, use future information to second-guess past decisions and seek to undo the consequences of past forecasting errors (not related to estimates). This violates the forward-looking nature of regulation as it exists at present, and changes the incentives for efficient investment that we currently have.

The risks presented by both of these issues can be minimised by undertaking the adjustment to reflect actual expenditure as soon as is practicable after the start of the access arrangement period immediately following the estimate (for example, at the end of year 1 of start of AAP2 in the Commission's Figure 3.1). Under this approach, the adjustment is made to revenue, not the capital base, and can be reflected over the remainder of AAP2 through the operation of the tariff variation mechanism to minimise the one-off

[3] Australian Energy Market Commission 2014, National Gas Amendment (Setting the Opening Capital Base) Rule 2014: Draft Rule Determination, 10 July, p 16

[4] We note the ERA's notion of adjusting in revenue is potentially feasible. However, one needs to be cognizant of double-counting; if actual capital spend is $5 million less than estimated, you cannot take $5 million of allowed revenues in one year of the following access arrangement and reduce the asset base by $5 million, because this counts the same impact twice. That is, the $5 million revenue adjustment brings forward the revenue stream that would have been associated with the full estimate of costs but which is no longer appropriate, and the reduction of the RAB also removes exactly the same revenues stream (but does so over time, rather than bringing it forward). In practical terms, then, using the ERA's scheme (unless subsequent over and under-estimates cancel each other out) may result in a RAB which bears little resemblance to actual assets deployed, and may lead to confusion.

price impact on customers. As the adjustment is happening soon after the difference arises, however, the price impact is likely to be minor, and will be significantly less than one that occurred five years hence, while still remaining NPV neutral.

We consider this approach would require changes to the NGR to make clear that such an adjustment can be made, and that it is appropriately made through the operation of the tariff variation mechanism during the access arrangement period that immediately follows the estimated year. This is likely to require changes to Rule 92(2) to make clear that a tariff variation mechanism may include an adjustment to take account of benefits or penalties arising from the rate of return associated with the gross difference between estimated and actual expenditure arising in the final year of the earlier access arrangement period.

We believe that the above proposed rule change better meets the National Gas Objective than that proposed by the AER due to its better incentive properties. To the extent that consistency between gas and electricity is important, mirror changes could be made to the electricity rules to reflect the above proposed rule change. This should have no real effect on electricity service providers, as all the rule change would do is bring forward an adjustment which already exists and remove the rate of return adjustment which is no longer required. We also recognise that our proposed rule change represents a difference in practice from the past, and it may be appropriate to implement a transition mechanism, particularly in respect of access determinations which are ongoing at the time any rule change is made.

In summary, DBP believes there is a rationale for a rule change, but that the aims of the AER's proposed change can be better met, and incentives for efficient investment less distorted, through an alternate rule change, as outlined above. If you would like to discuss any aspect of this proposed rule change, please do not hesitate in contacting me.

Yours sincerely

Anthony Cribb
General Manager Corporate Services
Company Secretary