AUSTRALIAN ENERGY REGULATOR

GPO Box 3131
Canberra ACT 2601

Telephone: (02) 6243 1233
Facsimile: (02) 6243 1205

www.aer.gov.au

Consumer
Challenge
Panel

CCP Sub-Panel CCP11

3 March 2017

To: Australian Energy Regulator (AER) Board

Ct: Lynley Jorgensen and Adam Young, Co-ordination Directors, Victorian Gas Access Arrangement Review (GAAR)

Dear Paula,

Victorian Gas Access Arrangement Review (GAAR) for APA VTS

Please find attached our advice in relation to the above Access Arrangement Review.

Kind regards,

Chris Fitz-Nead

Consumer
Challenge
Panel

Advice to the Australian Energy Regulator (AER)

Consumer Challenge Panel Sub-Panel CCP11

Response to proposal from APA VTS for a revenue reset / access arrangement for the period 2018 to 2022

Sub-Panel CCP11

David Prins

Bev Hughson

Robyn Robinson

Chris Fitz-Nead

3 March 2017

Contents

EXECUTIVE SUMMARY

CCP11 has considered the proposals of APA VTS (the Network Service Provider or NSP) in light of the objective of the CCP which is to:

- advise the AER on whether the network businesses' proposals are in the long term interests of consumers; and,
- advise the AER on the effectiveness of network businesses' engagement activities with their customers and how this is reflected in the development of their proposals.

In this Executive Summary, we summarise the issues of interest to CCP11 and our recommendations.

A. CONSUMER ENGAGEMENT

APA VTS (APA) has not yet developed an effective consumer engagement plan to inform its Access Arrangement proposal for 2018-22, nor undertaken any meaningful steps to enact such a plan.

CCP11 has discussed with APA the importance of having such a plan, following through with the plan and demonstrating how the plan influenced its Access Arrangement. CCP11 offered to provide feedback on the plan to APA prior to submitting APA submitting its Access Arrangement proposal. APA did not take up this offer, and did not demonstrate any strong commitment to developing a plan or taking specific actions to engage with Victorian gas consumers.

CCP11 recognises that a gas transmission company such as APA faces unique challenges in developing and implementing a broad based consumer engagement plan, given consumers' lack of knowledge of, and interest in, the role of transmission companies. Nevertheless, there are some excellent examples provided by electricity transmission companies that could have provided APA with some valuable insights if APA had sought their advice. ENA provides a useful Handbook on consumer engagement. Instead, APA has relied on third party consultative forums, such as those run by AEMO, to present aspects of its Access Arrangement and invite feedback from consumer representatives attending these forums. APA does not appear to have its own consumer representative forum.

The consumer engagement plan set out in the Access Arrangement shows very little evidence as to how APA has taken consumer feedback into account in its proposal, notwithstanding the major projects it has included in the access arrangement. APA is inviting "further suggestions on areas of targeted engagement with end use customers as part of a first step towards increased consumer engagement". There is no information, however, on how and when this process will proceed, despite the limited time available for APA to implement an effective plan to guide its very important investment decisions in the Access Arrangement. APA needs to show evidence of a far more structured and proactive plan, and one that provides clear indications about its purpose, timetable and measurable outcomes.

Overall, CCP11 is very concerned that APA has not progressed beyond the planning for the plan to implement an effective and sustainable customer engagement program. CCP11 cannot therefore establish if APA's Access Arrangement proposal adequately addresses feedback from its direct and indirect customers and other stakeholders.

B. LONG TERM INTEREST OF CONSUMERS

There are several issues in the APA's proposals which show or raise the prospect that the proposals are not in the long term interest of consumers. These are addressed in respect of APA VTS under the following areas of interest.

1. Demand Forecasts

CCP11 wishes to comment on the following aspects of APA VTS' demand forecasts:

- Differences between AEMO and APA VTS forecasts for Gas Powered Generation;
- Impacts of the Victorian Renewable Energy Target (VRET) scheme; and
- The basis of APA VTS forecasts for Tariff V residential gas use.

In the short term, based on modelling by Frontier Economics, APA VTS is forecasting higher levels of Gas Fired Generation (GFG) than AEMO is forecasting. The higher APA VTS forecasts drive significant capex.

There are differences between APA VTS forecasts and Victorian Government forecasts as to the impact that VRET will have on demand forecasts.

CCP11 finds it anomalous that ATA VTS has chosen to use distribution business forecasts as the basis for its forecasts for Tariff V residential gas use, rather than AEMO forecasts. AEMO forecasts are more generally used as they are independent of any business.

Recommendation:

- CCP11 advises the AER to consider whether ATA VTS should use AEMO forecasts, or whether the methodology used by APA VTS is equally acceptable.

2. Capital Expenditure

CCP11 has three areas of concern with the capital investment which are summarised here.

Current Period Overspend

APA estimates that it will spend $408.3 million capex in the period 2013 to 2017 compared to the $163.7 million allowed in Access Arrangement for that period increasing the RAB from $631.2 million to $1,007.3 million. The major element of this additional spending is the Victorian Northern Interconnect Expansion (VNIE) costing $339.2 million.

APA advises that the full costs of the VNIE are paid for by the shippers using the capacity created by this project to take gas from Victoria to NSW and Queensland markets. This is achieved by allocating the costs to the Culcairn withdrawal tariff: Culcairn being the location at which the VTS connects with APA's NSW gas transmission system. This may be true in the 2018 to 2022 period (and should be verified). However, there is no certainty that in the future, tariff schedules will not change, or quantities of export gas diminish, or export cease, so that Victorian gas users end up paying for part of this investment which would not be prudent and efficient capital investment without the export load. This capex needs to be quarantined from the RAB which determines the revenue requirement for Victorian consumers of gas from the VTS. It is not in the long term interests of Victorian consumers to pay for any part of an investment that is made for the benefit of companies shipping gas interstate.

Recommendations:

- The AER should consider whether the VNIE capex, made for the benefit of shippers moving gas interstate, is prudent and efficient, having regard to it being of limited or no benefit to Victorian consumers (and completely unjustified without the shippers taking gas interstate), and there being no certainly that by its inclusion in the RAB, those consumers may be required to pay for part of it in the future.
- If the VNIE capex is accepted, consideration should be given to whether tariffs in the proposed 2018 to 2022 recover all relevant costs from the shippers taking gas out of Victoria.
- The AER should explore how to ensure, over the regulatory life of the assets, that these costs are recovered from the beneficiaries of that expansion, not from all Victorian gas consumers. This may require changes to regulatory provisions to quarantine these costs so that the consumers of gas from the VTS only contribute to the fraction of the VNIE costs that benefits them.

Proposed Capital Expenditure: The Western Outer Ring Main (WORM) easement acquisition and the urban encroachment pipeline protection

APA VTS proposes acquisition of an easement for the WORM in the next Access Arrangement period even though it does not expect that the WORM will be required until around 2025. The early acquisition is costed at $26.7 million, and is justified by APA because

- It will reduce the overall cost by more than the time cost of the advance purchase; and
- It ensures that the preferred route is secured (before urban encroachment makes it impossible), thus avoiding having to use a longer and more expensive route.

If these justifications are not robust and there is insufficient certainty that the WORM will be constructed when proposed, then the early acquisition is unlikely to be either a prudent and efficient investment or in the long term interests of consumers.

APA proposes carrying out $27.3 million of works at several pipeline locations where urban encroachment over the decades since the pipeline was laid is said to have increased the risk of damage to that pipeline. APA has provided an independent review regarding the basis of its risk assessment, but not of the assessment and conclusions. Slabbing (laying a protective concrete barrier above the pipeline) is proposed in all cases.

For one of the pipeline protection projects, on the pipeline between Wollett to Wodonga (part of the VNI), this option is $1.1 million more expensive than the alternative of reducing pressure. APA notes that reducing pressure will impact capacity for gas flowing to NSW. It is not in the long term interests of Victorian consumers to incur the extra capital expense (now or in the future) for a project that can only be considered a prudent and efficient investment if supported by exports of gas and one from which Victorian gas users gain no real benefit.

Recommendations:

- The AER should examine the case made for the early acquisition of the easement for the WORM to evaluate its merit. If the suggested cost savings are robustly supported and there are firm prospects that the WORM will be constructed by 2025, the AER might consider approving the investment. If there is reasonable doubt, then the AER might consider options such as allowing a pass through event following a firm decision to construct the WORM.
- The AER should consider engaging an expert to review the APA risk assessments associated with the urban encroachment pipeline protection projects. It should consider the appropriateness of the selection of the more expensive slabbing option for the VNI (on the information supplied, seemingly because of the capacity needs for gas to be delivered to NSW) and if appropriate, treat the extra $1.1 million cost as capital to be recovered, over its regulatory life, from shippers exporting gas.

Expense Classification – Pipeline Inspection

APA notes that some items of major maintenance activity are capitalised and amortised over short periods for regulatory purposes while these same items are expensed for tax purposes. Pigging of pipelines is the example given and this represents a proposed $16.6 million in the period 2018 to 2022 (and a smaller amount in the current period). If costs, which should be considered operating costs, are capitalised into the RAB, then the revenue requirement is increased. This is not in the long term interest of consumers.

Recommendation:

- The AER should examine pigging and the other items that APA capitalises for regulatory purpose but treats as operating expenses for tax purposes, including looking at how the same expenses have been treated by other transmission pipeline owners and provided for in Access Arrangements. If APA's inconsistent treatment is not justified, then these expenses should be treated as operating expenses for regulatory purposes.

3. Operating Expenditure

APA VTS is forecasting an overall small increase in operating expenditure over the next AA period with reductions in insurance costs and corporate overheads being offset by proposed step and scope changes. CCP11 considers that some of the proposed opex changes warrant further scrutiny.

Recommendations:

- The AER review APA VTS's corporate overhead allocation methodology to ensure that corporate overheads are being appropriately allocated between opex and capex, and to the appropriate tariffs.
- The Southbank lease opex step change be rejected on the basis that it is not a new business obligation, rather a replacement of costs which were previously included in base year opex.
- The AER ensure that all costs associated with the VNI expansion are allocated to appropriate tariffs, and that Victorian consumers are not paying any more than their fair share of the VNI expansion costs.

- The AER seek justification of the APA VTS estimate of the valuation of the spares inventory.

4. Rate of Return & Inflation

R*ecommendations:*

Regarding the Equity Beta
- The AER should not accept APA's proposal for an increase in the equity beta.
- The AER could investigate further the claim that there has been a change in the equity beta for a BEE since 2014 based on the 5-year analysis. The 10-year analysis by Frontier suggests that a longer-term perspective such as that adopted by the AER is more relevant and reliable. The range and point estimates in the AER's Guideline are consistent with this longer-term analysis.
- The AER should consider the views of the ERA with respect to the Black CAPM.

Regarding the MRP
- The AER should not accept APA's proposal for an increase in the MRP.
- The AER could investigate further the claim that there has been a change in the dividend growth model outputs in recent years and whether this change represents a permanent change in the market environment or it reflects short term sentiment in the market.
- The AER's SL CAPM takes a longer view on the MRP than other regulators. Given that the AER's SL CAPM is built around a 10-year regulatory horizon, the longer term view is appropriate. The AER might investigate whether it should just rely on historical excess returns and whether the DGM remains a useful tool to capture this longer term view
- The 10-year analysis by Frontier suggests that a longer-term perspective such as that adopted by the AER is more relevant and reliable. The range and point estimates in the AER's Guideline are consistent with this longer-term analysis.
- The AER should consider the views of the ERA with respect to the Black CAPM.

5. Tariffs

CCP11 has concerns with the following two aspects of APA VTS' tariff proposals:
- APA VTS' 'cap and collar' proposal; and
- Cost recovery of the significant expansion of the RAB and additional opex and depreciation arising from the VNIE project discussed at length in section 2.

Recommendations:

- If APA does propose to reinstate a 'cap and collar' mechanism, the AER should consider what risks might arise for Victorian gas consumers if the mechanism were to be approved, and whether it is appropriate for the consumers to bear those risks.
- The AER should ensure that the arrangements put in place in this regulatory determination fully quarantine all the costs associated with expenditure to benefit interstate shippers of gas from Victoria into New South Wales with separate accounting and reporting. This should be coupled with ensuring that it is in accordance with the National Gas Rules to disallow recovery of these quarantined costs from Victorian consumers.

6. Access Arrangement

APA proposes a new cost pass through event of “new gas market structure development event”. It also proposes amending the “carbon cost event” in its current Access Arrangement, which is precisely defined by reference to the costs under the now defunct Clean Energy Act 2011 (Cth), with the effect of making the meaning and scope less certain. In both cases, the imprecision and risk of pass through of inappropriate costs is not considered to be in the interests of consumers.

It appears that APA’s concerns can be addressed by existing pass through events: the tax change event and/or the regulatory change event (both common to NSPs’ Access Arrangements and well understood). Consumers are also likely to be best served by there being a limited range of common pass through events which have widely understood scope, and which the AER is experienced in applying.

Recommendations:

- The AER should assess whether the proposed definition of new gas market structure development event could include costs that it might typically be consider operating expenses and whether the legitimate concerns of APA are addressed under the existing regulatory change pass through event.
- The AER should not accept amendment to, or continuation of, the definition of carbon cost event in APA’s Access Arrangement if it is satisfied that APA’s legitimate concerns are covered by other existing pass through events.

BACKGROUND

- This advice was prepared as agreed between sub-panel CCP11 working on the APA VTS (the NSP) Access Arrangement, and Lynley Jorgensen and Adam Young, Co-ordination Directors for Vic GAAR.
- CCP11 was established in September 2016.
- On 16 November 2016, CCP11 met in Melbourne with the business to discuss its consumer engagement processes, the key elements of its proposal (i.e. high-level drivers, priorities, issues and challenges for the business and how these issues were reflected in the proposal), and its key consumer issues.
- CCP11 arranged a forum in Melbourne on 5 December 2016 to meet with consumer representatives. CCP11 invited all parties who had been involved in consumer engagement with each network business in the Vic GAAR process. Three people attended the forum. Separately, members of CCP11 met with several other consumer representatives.
- On 1 February 2017, CCP11 participated in the Public Forum convened by the AER in Melbourne. This Public Forum was primarily an opportunity for engagement with the network businesses, with limited attendance by consumer representatives.
- CCP11 has held regular meetings with the Co-ordination Directors since September 2016.
- Meetings have been held with most of the AER specialist teams involved in the Vic GAAR. These meetings have provided an opportunity for CCP11 to increase their understanding of some of the technical issues involved, as well as for the Panel and AER officers to exchange view on issues associated with the Vic GAAR proposals.

ADVICE ON

A. Consumer Engagement

The effectiveness of network businesses' engagement activities with their customers and how this is reflected in the development of the network businesses' proposals

1. Effectiveness of Consumer Engagement

1.1 Introduction

APA VTS's (APA) consumer engagement plan is set out in an attachment to its 2018-22 Access Arrangement proposal.[1] This document, along with meetings and written communication with APA in November and December 2016 provides the main source material for CCP11's assessment of the effectiveness of APA's consumer engagement (CE) plan and the implementation of the plan.

CCP11 met with a representative of large consumers to discuss their experiences with APA, and attended a Consumer Forum conducted by the Australian Energy Market Operator (AEMO) where APA provided a high level presentation on its Access Arrangement.

As a gas transmission company with fewer than 25 direct customers, APA is in a somewhat unique position when it comes to engagement with Victorian gas consumers, and this inevitably influences the structure and content of its consumer engagement program.

Given this unique position, CCP11 recognises that there is no 'boiler plate' consumer engagement process available to APA. The development of an effective consumer engagement program in these circumstances requires both initiative and commitment by APA at an early stage in the development of its Access Arrangement.

However, there are electricity transmission companies that face similar challenges and have developed effective consumer engagement programs, and they may provide some guidance notwithstanding APA's circumstances may be different again. The AER has also provided a useful framework for consumer engagement by network service providers in its 2013 Consumer Engagement Guideline.[2] Similarly, the ENA has developed a Consumer Engagement Handbook following extensive consultation with consumers and network companies. The publicly available IAP2 Public Participation Spectrum also sets out the levels of public participation, and the actions that are required in order to achieve these levels.

It is not clear from CCP11's meetings with APA or from APA's CE plan, whether APA has engaged with these other transmission companies or referenced the AER's Guideline, the ENA Handbook or the Public Participation Spectrum (to name just some sources of guidance for APA).

[1] APA – *Victorian Transmission System, Consumer engagement plan*, Phase 1 – Consumer identification and current levels of engagement, December 2016

[2] AER – *Better Regulation Consumer Engagement Guideline for Network Services Providers*, November 2013

Overall, CCP11 is concerned that APA's consumer engagement program is still at a very early stage in its development. This concern was communicated with APA at various times in late 2016. CCP11's ability to assess the extent to which APA's Access Arrangement reflects feedback from its direct and indirect customers is significantly hampered by the absence of a well-developed engagement plan and an effective process to implement that plan.

APA acknowledges this gap and the need to progress its consumer engagement program. In its CE Plan, attached to its access arrangement proposal, APA states:[3]

> *APA is committed to developing and implementing an effective Consumer Engagement Plan. We acknowledge that, with respect to engagement with small end uses of gas, we are at the very start of the process and there is considerable scope to grow.*

APA then outlines the 'next steps' in its CE Plan. The next steps involve two initial areas that APA would like to investigate with consumers, namely "education" and "information sharing and publication". These are the very earliest stages of an effective consumer engagement process, and barely meet the requirements of even the lowest level of consumer engagement, the 'inform' level of the IAP2 Public Participation Spectrum.

While CCP11 welcomes APA's commitment to develop its consumer engagement plan, it is also apparent that the current access arrangement has been prepared without the benefit of broader consultation with gas users. Indeed, the process of consulting with gas users on the CE plan itself is still in its infancy.

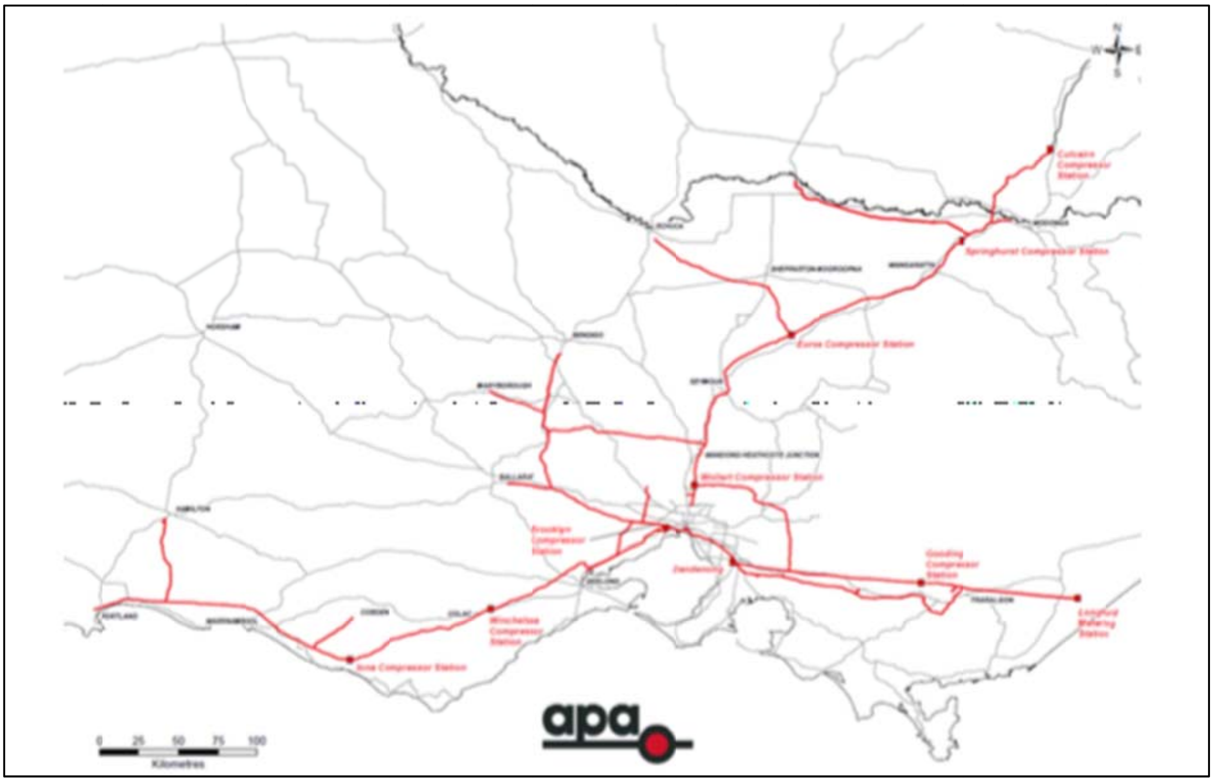
1.2 APA's consumer engagement to date

APA is the major national gas transmission service provider with gas transmission pipelines operating in the majority of states in Australia. It acts as a vital link between the main centres of gas production and demand, and has a key role to play in Australia's overall energy market.

The majority of APA's gas transmission pipelines are either unregulated or subject to light-handed regulation. The Victorian gas transmission system represents APA's largest regulated pipeline asset on the East Coast. In Victoria, APA's transmission pipeline forms the vital backbone of gas supply to all Victorians, as illustrated in Figure 1.1 below.

[3] APA, *Victorian Transmission System, Consumer engagement plan*, Phase 1 – Consumer identification and current levels of engagement, December 2016, p. 11.

Figure 1.1: APA's Victorian Transmission System



Source: APA VTS *Victorian transmission system access arrangement submission*, 3 January, 2017, Fig. 1-1, p. 8.

CCP11 recognises that APA's consumer engagement plan needs to be tailored to its relatively unique circumstances that include:

- APA has fewer than 25 direct customers in Victoria. These direct customers include a range of large businesses with extensive commercial experience;
- APA's experience in the past has been largely focused on its commercial relationships with these large businesses;
- Under the market rules in Victoria, APA is the operator of the VTS but is not the planner, and the market arrangements limit APA's contact points with gas users;
- APA's contact with large customers and shippers/retailers in Victoria is, however, changing rapidly as the Victorian transmission system becomes increasingly interconnected with other states and new generators; and
- There is a low level of awareness of, and interest in, gas transmission by small gas users in Victoria; gas transmission charges represent a very small component of small customers' energy bills.

Notwithstanding the current low level of interest in gas transmission among small gas users, APA plays a vital role in ensuring the security of Victorian gas supply and, increasingly, supply to other states. APA's decisions on investment in the Victorian gas transmission network will have both strategic and security significance to large and small customers alike, highlighting the importance of APA having an effective means of engaging with both its direct and indirect customers in the development of its Access Arrangement proposal.

Direct customer engagement

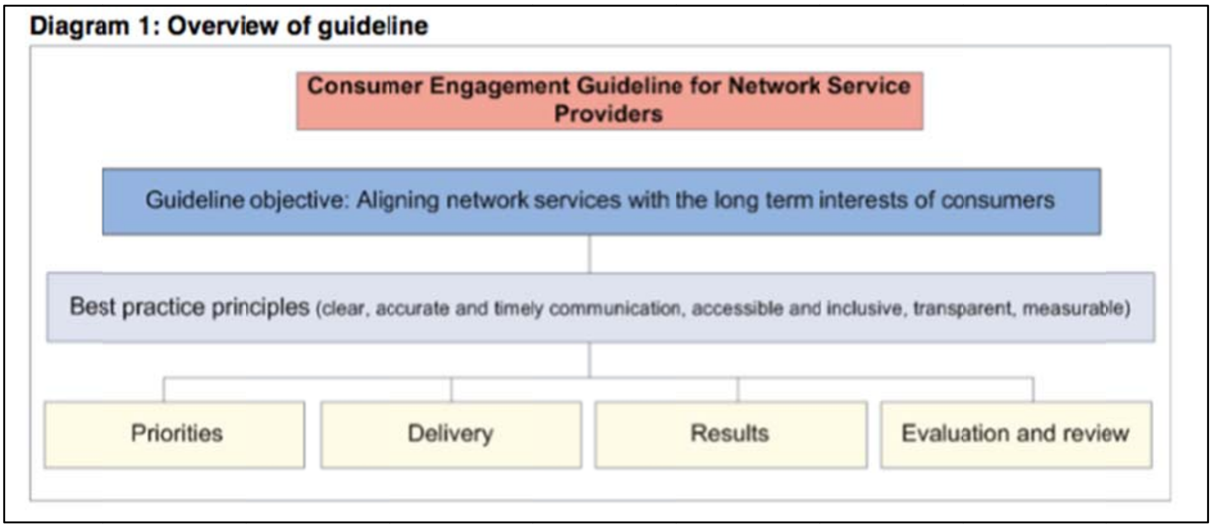
APA indicates that its engagement focus to date has been with industry bodies, shippers, retailers, generators, large customers and industry working groups. It sees these working groups as an opportunity to develop commercial and business relationships and to contribute to the strategic planning of the gas industry generally. APA summarises the nature of this contact with the direct users of the transmission system as follows:[4]

- direct account management;
- day-to-day operation of the system (noting that APA has limited influence on the day-to-day operation of the system under the Victorian market carriage model);
- capacity development, responding to the changing needs of both existing and potential direct customers;
- information sharing and publication, including the development of web-based services; and
- new services development.

These are appropriate activities for the day-to-day operation of a commercial business. However, they do not meet the intent of the consumer engagement programs required as part of the access arrangement development process; more is required. An effective consumer engagement program, even if restricted just to direct customers, needs to be built around a clear framework of objectives, principles, action and measurement, and be focused on APA's plans.

A useful starting point is set out in the AER's Consumer Engagement Guideline that provides a high level framework for effective consumer engagement as illustrated in Figure 1.2 below.

Figure 1.2: AER's conceptual framework for effective consumer engagement.
Source: AER, *Consumer Engagement guideline for network services providers*, November 2013, p. 7.



Small customer engagement

APA acknowledges in its CE Plan that it has had even more limited engagement with small customers and small customer representative groups. APA states that this is because APA has no direct

[4] APA, *Victorian Transmission System, Consumer engagement plan*, Phase 1 – Consumer identification and current levels of engagement, December 2016, p.p. 6 – 7.

contractual or business relationship with these end users, and therefore has difficulty identifying these users.[5]

APA also states in its CE Plan that: "better engagement with end users of gas has been identified as a key area for development for APA's Consumer Engagement Plan".[6]

However, it seems that this engagement with small consumers has to date been limited to APA attending industry working groups that include representatives from consumer groups.

As APA notes, these industry groups are largely run by the energy market institutions, and the groups are intended to address industry issues. In particular, the focus of these working groups is on specific industry issues, and they are not tasked with contributing to the development of APA's Access Arrangement proposals or even APA's capital expenditure plans (in most cases). The benefits of attending these working groups to APA are around participating in energy policy development, sharing ideas, and building relationships "as a basis for future engagement".

APA has recently started to attend the AEMO Consumer Forum. This Forum has a more general information-sharing objective than the industry working groups and includes representatives from different consumer organisations. While this gives APA an opportunity for closer relationships with consumer groups and to hear their general concerns, the Forum does not have a detailed focus on APA's Access Arrangement proposals.

APA has no dedicated consumer forums of its own where consumers can assess APA's CE Plan or consider the issues raised in the access arrangement proposal in any depth. Nor does APA appear to have any mechanism to ensure it has an ongoing, constructive and interactive engagement with its direct and indirect customers.

CPP11 attended one of AEMO's Consumer Forums in late 2016 where APA was invited to present an overview of its access arrangement proposal.[7] The presentation was very high level, and APA appeared to find it difficult to get consumers engaged on many of the issues that were important to its access arrangement. Further engagement with the access arrangement process was left open ended, with APA stating that it was seeking to "open the dialogue with Victorian gas users to be able to reflect their views in the AA development process".[8]

Unfortunately, APA's CE plan ends on a similar note, as follows:[9]

> *APA would welcome further suggestions for areas of targeted engagement with end users as part of this first step towards increased consumer engagement.*

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[5] Ibid, p. 9
[6] Ibid
[7] APA's presentation is available on AEMO's web-site. https://www.aemo.com.au/Stakeholder-Consultation/Industry-forums-and-working-groups/Other-meetings/Consumer-Forum. The presentation is dated 5 February, although the presentation attended by CCP11 occurred in November 2016.
[8] See APA presentation (cited above), page 5
[9] Ibid, p. 12

CCP11 is concerned that the offer to "open a dialogue" or for consumers to provide "further suggestions" gives no direction to consumers on the 'how or the when'; nor does it clearly define the objectives of such an engagement. An open ended offer risks receiving no response. APA's Access Arrangement provides no clarity on whether the dialogue has been undertaken or whether consumers did respond to the offer for suggestions.

This is particularly concerning given how late in the regulatory process it is, leaving little time for consumers to undertake meaningful engagement with APA. CCP11 would recommend that APA takes a much more proactive approach to developing and implementing its CE plan, particularly given the real challenges it faces as a gas transmission company in engaging its customers.

1.3 Learnings from Consumer Engagement

APA has, no doubt, talked over the years to its direct customers and participated in many industry forums. APA has also presented a high level overview of its Access Arrangement to AEMO's Consumer Forum to begin to build relationships with consumer representative groups and, more specifically, to obtain feedback on the Access Arrangement.

However, APA provides very limited indication of how feedback from its direct and indirect customers have informed its Access Arrangement despite the inclusion of some major projects in the access arrangement that will have important impacts on the long term cost and security of supply to Victorian gas consumers.

1.4 Consumer representatives' expectations

CCP11 has had limited opportunity to discuss APA's consumer engagement program with either its direct or indirect customers. It is an area that CCP 11 anticipates will be more productive over the next few months as APA expresses its intent to develop its CE plan.

The limited feedback that CCP11 has received from one-on-one interviews with APA's customers and consumer representatives suggests:

- Consumer representatives have limited contact with APA outside industry forums. However, consumer representatives also indicated that there was little interest in APA's proposal given the relatively small impact APA's charges currently have on small customer gas bills in Victoria and, given the limited resources available to consumer advocates, it was difficult to justify participation in a CE program.
- However, at least one consumer advocate emphasised the need for transparency in the gas supply chain and the importance of not over-investing in new gas infrastructure.
- The large customer representative stated that large customers are more aware of and affected by APA's activities and transmission charges, and do have an interest in APA's strategic and pricing decisions, as well as any proposed augmentation of the transmission network. While there are semi-regular contacts with APA in various industry forums and with respect to specific commercial and operational matters, the representative noted the lack of a structured and ongoing engagement program. This representative considered that APA was still operating at a very low level of consumer engagement as defined by the IA2.

1.5 Conclusions

In CCP11's view, APA's consumer engagement processes to date still reflect a business whose focus is on its formal commercial and operational relationships with large customers, retailers, shippers, generators and the like. Its contact with small gas users is limited to participation in, and presentations to, third party industry working groups and the AEMO's Consumer Forum.

APA's CE plan to develop a broader consumer engagement process in line with the industry consumer engagement standards was first seen by CCP11 in APA's current Access Arrangement proposal.

The CE plan is clearly in the very earliest stages of development, and APA acknowledges this problem. The plan has very little detail about how and when APA will progress the further development of its CE plan and its implementation in the lead up to its revised Access Arrangement.

It is recognised that transmission companies have very limited interfaces with most customers and that these customers generally have a low level of interest in, and knowledge of, the activities of transmission companies and their importance to the security of energy supply to their homes and businesses. This limited knowledge is particularly evident in the case of gas transmission companies.

Nevertheless, this is not a reason for not engaging with these consumers. Rather, it emphasises the importance of early investment in the planning of CE and ongoing commitment of the management of the business to the CE plan.

CCP11 highlights that there are excellent examples of electricity transmission companies undertaking effective engagement despite the obstacles and the businesses themselves benefit from a better understanding of their final customers. CCP 11 encourages APA to learn from their experience while adapting this experience to the unique challenges that APA faces.

At this stage, CCP 11 finds little evidence as to how (if at all) APA has taken account of the feedback from its customers (direct or indirect) in its access arrangement proposal. For this reason, we cannot with any surety advise the AER that APA's access arrangement reflects effective consultation with its customers. CCP 11 does, however, look forward to seeing how the APA CE plan develops over the next few months.

B. Long Term Interests of Consumers

Whether the network businesses' proposals are in the long term interests of consumers

1. Demand Forecasts

CCP11 wishes to comment on the following aspects of APA VTS' demand forecasts:

- Differences between AEMO and APA VTS forecasts for Gas Powered Generation;
- Impacts of the Victorian Renewable Energy Target (VRET) scheme; and
- The basis of APA VTS forecasts for Tariff V residential gas use.

Differences between AEMO and APA VTS forecasts for Gas Powered Generation

In the short term, based on modelling by Frontier Economics, APA VTS is forecasting higher levels of Gas Fired Generation (GFG) than AEMO is forecasting. The higher APA VTS forecasts drive significant capex.

We understand that the differences between the forecasts stem from different assumptions about carbon pricing. The AEMO forecast is based on a carbon pricing scheme being in place in Australia, which is quite possible under a future Australian government. On the other hand, APA VTS and its consultant Frontier Economics point to the fact that there is no such carbon pricing scheme in place, and there is no suggestion at the moment that the current Australian government will put such a scheme in place. On that basis, they propose that it would be wrong to estimate future demand based on an assumption that such a scheme will be in place.

We understand both arguments. It is not for CCP11 to pontificate on the likelihood of future Australian political outcomes that would drive the existence or otherwise of a carbon pricing scheme. Rather the AER must determine an appropriate forecast, taking into account the importance of the forecast as a driver of capex.

Impacts of the Victorian Renewable Energy Target (VRET) scheme

There are differences between APA VTS forecasts and Victorian Government forecasts as to the longer term impact that VRET will have on demand forecasts. We advise the AER to analyse the differences to determine the best estimate of what impact it believes VRET will have on the demand forecasts.

The basis of APA VTS forecasts for Tariff V residential gas use

CCP11 finds it anomalous that ATA VTS has chosen to use distribution business forecasts as the basis for its forecasts for Tariff V residential gas use, rather than AEMO forecasts. AEMO forecasts are more generally used as they are independent of any business.

Recommendation:

- CCP11 advises the AER to consider whether ATA VTS should use AEMO forecasts, or whether the methodology used by APA VTS is equally acceptable.

2. Capital Expenditure

2.1 Current Period Overspend

What the business has proposed

APA has spent nearly 150% more on capex in the current period than the expenditure approved by the AER: APA estimates that it will spend $408.3 million capex in the period 2013 to 2017 compared to the $163.7 million allowed in the AER's Final Decision.[10]

If accepted by the AER, this capex will have the effect of substantially increasing the Regulated Asset Base (RAB) from $631.2 million to $1,007.3 million.[11] APA will earn a return on this new investment for decades to come, which means generations of consumers pay for the investment and APA's return. Return on capital makes up around two thirds of the revenue requirement APA is claiming in the next period.[12]

The major element of the additional spending in the current period is the Victorian Northern Interconnect Expansion (VNIE), which is an expansion of the Gas to Culcairn project approved by the AER in the current Access Arrangement period.[13] Gas to Culcairn involved an $85.2 million investment in capacity expansion and system enhancement in the South West Pipeline (SWP) and the Victorian Northern Interconnect (VNI) with among other things, new compression for the SWP and some looping on the VNI. The VNI is the trunk pipeline that runs through northern Victoria servicing Victorian communities and southern NSW consumers (in Albury and surrounds) and on to Culcairn, the location at which the VTS connects with APA's NSW gas transmission system.

After this approval, APA received requests for further capacity in the SWP and at Culcairn associated with changes to the national gas market including commissioning of three LNG plants in Queensland and demand for Victorian gas in NSW. These increases in demand marginally changed the scope of the SWP works and significantly changed the scope of the works with the looping of the VNI.[14] The final VNIE project cost $339.2 million,[15] and resulted in full looping of the VNI from Wollett to Barnawartha (more than doubling the capacity for gas northern flows through the VNI to 201TJ/day),[16] and installation of a more powerful new compressor at Winchelsea to expand flows through the SWP.

APA advised in its presentation at the AER Public Forum on 1 February 2017[17] that the capital costs of the VNI expansion project are paid for by the users of that new capacity. APA explains that this is achieved by these costs being allocated to the Culcairn withdrawal tariff: Culcairn being the northern

[10] APA – Victorian Transmission System - Access Arrangement submission 3 January 2017 p.60
[11] Ibid p.125
[12] Ibid p.214
[13] Ibid p.63
[14] Ibid p.63
[15] Ibid p.67
[16] Ibid p.29
[17] APA VTS – Presentation at AER public forum – 1 February 2017 p.16

end of the VNI and the location at which the VTS connects with APA's NSW gas transmission system and from where gas can be shipped to NSW and Queensland markets.

APA says in the presentation that:

> *Victorian domestic customers do not bear the costs of the VNI expansion and receive benefit from the reduced allocation of common costs.*[18]

In this presentation, APA indicates that "Total VNIE project expenditure [is] $299 million".[19] This is the cost of the Wollett to Barnawartha expansion of the VNI,[20] not the total project cost of $339.2 million. Also, the statement quoted above refers to the "VNI expansion" rather than the full Gas to Culcairn project. It is, therefore, unclear to what extent Victorian gas consumers are bearing the cost of the capacity enhancement on the SWP costing $40.3 million (exceeding the AER approved $38.6 million) to meet the demand for gas at Culcairn.[21]

The massive investment in the expansion of capacity for gas to flow to markets outside the VTS appears to provide some small potential benefit to Victorian gas consumers by adding additional storage and capacity for importing gas to Victoria. Gas flows toward Melbourne from NSW have increased since 2013 from 120TJ/day to 125TJ/day in 2017,[22] so the expansion in the VNI makes a negligible difference to the amount of gas that can be brought to Victorian consumers if needed. Further, APA notes that it may not be relied on during peak winter demand:

> *For example, injections from NSW via the Interconnect may not be available if the Uranquinty Power Station is operating or if there are gas exports through Culcairn to supply NSW customers or for LNG in Queensland.*[23]

The expansion of the SWP capacity is likely to provide benefits to Victorian gas consumers by increasing capacity to bring gas to the Melbourne market. However, as part of the original Gas to Culcairn project, its primary purpose appears to be to supply capacity for export gas. The benefit to Victorian consumers of the investment in the SWP approved by the AER in the current Access Arrangement needs to be examined to assess to what extent Victorian consumers should contribute to the cost over it regulatory life. The cost of the upgrade to a more powerful compressor at Winchelsea compressor than originally planned appears likely to be wholly attributable to shippers taking gas through the VTS to NSW.

In the short and longer term the only apparent beneficiaries of the Wollett to Barnawartha looping and part of the SWP expansion are the companies shipping gas through the VTS to the NSW and Queensland markets. Therefore, if the full cost of this investment over its regulated asset life (of up

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[18] Ibid p.16
[19] Ibid p.6
[20] APA Victorian Transmission System - Access Arrangement submission 3 January 2017 p.67
[21] Ibid pp. 63-64
[22] Ibid p.28
[23] Ibid p.93

to 55 years[24]) cannot be recovered from businesses shipping gas to northern markets, the investment may not be considered prudent or efficient.

The difficulty here is linked to the unique regulatory structure of the VTS which does not permit bi-lateral contracts. In a typical contract carriage transmission pipeline, the owner of the pipeline system, responding to market demand for capacity that is of no value to other system users, could have contracted with the shippers of gas through the VTS to NSW to recover the full capital and operating costs of the expansion from them over the term of their contracts.

As noted above, APA says that in the next Access Arrangement period the full cost (of the Wollett to Barnawartha looping or the VNIE?) is recovered from those shippers. This may be correct but needs to be verified. However, tariff schedules can change from one Access Arrangement to the next so there is no certainty that in the future, particularly if quantities of export gas diminish or export ceases, this will change, and Victorian gas consumers may well be asked to pay for part of this investment. Theoretically, in this situation the AER could determine the asset to be redundant thus removing its remaining value from the RAB (National Gas Rules, Rule 85). In practice, it may be difficult to show that the asset is redundant for example because it is partly used, it may be needed again soon or it has been used for some storage or emergency event. The issue may also just be forgotten over the up to 55 year life of the assets allowing the costs of the VNIE to creep onto Victorian gas consumers.

Ideally the investment made for the benefit of shippers of gas through the VTS to interstate markets would be quarantined from the RAB which determines the revenue requirement for consumers of gas off the VTS. This may not be possible under existing rules in which case consideration should be given to a rule change to establish a framework that ensures that consumers taking gas off the VTS pay only for the fraction of these assets that they use.

Consumer perspectives

There is a real risk that in the future Victorian gas consumers will contribute to the costs of the VNI expansion and the SWP expansion, which investment has been made for the benefit of companies shipping gas through the VTS to NSW and Queensland. It is not in the long terms interests of these consumers for them to pay for any part of assets that do not benefit them.

Recommendations:

- The AER should consider whether the VNIE capex, made for the benefit of shippers moving gas interstate, is prudent and efficient having regard to it being of limited or no benefit to Victorian consumers (and completely unjustified without the shippers taking gas interstate) and there being no certainly that by its inclusion in the RAB, those consumers may be required to pay for part of it in the future.
- If the VNIE capex is accepted, consideration should be given to whether tariffs in the proposed 2018 to 2022 recover all relevant costs from the shippers taking gas out of Victoria.
- The AER should explore how to ensure, over the regulatory life of the assets, that these costs are recovered from the beneficiaries of that expansion, not from all Victorian gas consumers. This

[24] Ibid p. 127

may require changes to regulatory provisions to quarantine these costs so the consumers of gas from the VTS only contribute to the fraction of the VNIE costs that benefits them.

2.2 Proposed Capital Investment

What the business has proposed

In the next AA period APA proposes capex of $168.4 million.[25] There are two items of this investment that CCP11 has identified as being of particular interest:

- The Western Outer Ring Main (WORM) easement acquisition – $26.7 million;[26] and
- Urban encroachment pipeline protection – $27.3 million.[27]

The WORM

The WORM is a proposed new pipeline around part of outer Melbourne. The benefits of the WORM are said to be that it will:[28]

- Improve security of supply in the event of a supply source failure by allowing alternate supply to reach the market;
- Allow flows between the east and west of the system supporting the system functioning in tighter bands of operation;
- Provide storage, proximate to the major Melbourne demand centre, improving the system's capability to meet peak demand day requirements; and
- Allow great readiness in gas fired generation plant.

APA VTS proposes acquisition of an easement for the WORM in the next Access Arrangement period, even though it does not expect that the WORM will be required until around 2025. The benefits of early acquisition of the easement are said to include the following:[29]

- The acquisition will reduce the overall cost by more than the time cost of the advance purchase; and
- Ensuring that the preferred route is secured (before urban encroachment makes it impossible), thus avoiding having to use a longer and more expensive route.

The AER did not approve the WORM project at the last Access Arrangement review, but it did note in the Final Decision that the completion of the outer ring main around Melbourne was considered "*to have merit from a technical perspective and in the future, prove to be a prudent response to the augmentation needs of the VTS in the longer term*."[30]

In considering whether the easement acquisition capex is prudent and efficient expenditure for the next period, the AER should consider whether the easement will be a productive asset that is appropriate for inclusion in the RAB. If it considers that this is possible, it needs to assess the merit of the WORM as well as whether it is likely to be constructed in the timeframe suggested by APA. The AEMO Gas Statement of Opportunities 2017, expected to be available in March, should provide up to date assessments of forecast system constrains and peak day demand issues which will assist this consideration. If there is a real risk that the requirement for the WORM would be delayed or

[25] Ibid p.87
[26] Ibid p.97
[27] Ibid p.104
[28] Ibid p.95
[29] Ibid p.96
[30] Ibid p.96

that it might not be required at all, the value of early acquisition is unlikely to be supported. The AER will also need to consider whether there is a real risk that urban encroachment is likely to result in a more expensive development if easement acquisition is delayed until the business case to build the pipeline is full made.

If this capex is accepted by the AER, consideration also needs to be given to whether the WORM provides a material benefit to the flow of gas through to NSW, and if so then how the beneficiaries of that flow contribute to its cost to ensure that Victorian consumers are not subsidising export gas.

Urban encroachment pipeline protection

APA proposes carrying out works at several pipeline locations where urban encroachment over decades since the pipeline was laid has increased the risk of damage to that pipeline. APA says that the works to be carried out involve parts of the VTS not designed for residential areas. These parts of the pipeline system originally passed through rural zones, but are now operating in residential and high density areas. Some of this change in land use is a result of government action in 2011 which enlarged the metropolitan area of Melbourne.[31] For pipelines in these areas, APA determines the risk of rupture (by impact from a backhoe or the like) to be Intermediate.[32]

APA identifies two broad approaches to reducing the risk associated with pipeline rupture from external interference or mechanical damage threats:

- Pressure reduction – lower pressure means a lower consequence of puncture as the force of the gas behind the rupture is reduced.
- Slabbing – this puts a physical barrier (a concrete slab) above the pipeline which acts as a deterrent to the operator of the excavator or other equipment from rupturing the pipeline.

APA's proposal includes a business case for the proposed work to protect sections of pipeline identified as requiring protection.[33] This outlines how APA has assessed the risks pursuant to the relevant Australian Standard. It identifies the best option to address the risk, including those noted above, as well as doing nothing or replacing the pipelines with a higher standard of pipe. APA determines that doing nothing is not an acceptable option, and that the best option for all the identified at-risk sections of pipeline is slabbing.

APA's proposal includes an independent consultant's review,[34] which confirms that APA has applied the relevant Australian Standard and risk assessment approach in its assessment. It does not review the APA risk assessments or their conclusions.

The slabbing option is materially cheaper than pressure reduction in one of the three major projects. In the other two projects, slabbing is preferred, as lowering pressure is said to result in the need for further pipeline augmentation to meet demand requirements. One of these projects is on parts of pipeline between Wollett to Wodonga (part of the VNI). The business case says that the reduced pressure option while cheaper will add some operating costs relating to the maintenance and replacement costs of a Pressure Reduction Station (PRS) and:

[31] Ibid p.101
[32] Ibid p.101
[33] APA VTS – D22 – BC230 Encroachment High Consequence Areas – 20161230 – Public
[34] APA VTS – D3 – Urban encroachment business case review – 20161221 - Public

> *In addition, the PRS will create another load on the T120 Victorian Northern Interconnect thus increasing the usage on Wollert Compressor Station B and reducing the capacity available for export into New South Wales.*[35]

So, it appears that unspecified additional operating costs and capacity for gas being exported to NSW and Queensland is the basis for selection of slabbing which has a capital cost that is $1.1 million[36] more than the pressure reduction option. It would be useful to understand the expected additional operating costs associated with the PRS and the additional compression as well as the relationship between these and supplying capacity for export gas so as to consider how these costs might be allocated between Victorian consumers and shippers taking gas to NSW. Subject to considering the additional operating costs, if the slabbing option is undertaken the $1.1 million of additional capital expense may, over its regulatory life, need to be included in the Culcairn tariff payable by export gas.

Consumer perspectives

Where there is no business case and plan for the construction of the WORM, there is some doubt as to whether the costs of acquiring the easement should be included in the RAB thus requiring consumers to begin paying for it.

If it is determined that:

- The early acquisition of the easement for the WORM is required to secure the most cost effective route; and
- The construction is to proceed within the period that the time cost of the early acquisition is economically justified

Then

- The inclusion of the easement acquisition cost in the RAB would be justified and would be in the long term interests of consumers.

This is a difficult test particularly as to the degree of certainty that the construction will proceed if there is not firm commitment to that.

The proposed urban encroachment pipeline protection capital would be in the long term interests of consumers if the conclusions from the risk assessment are reasonable. Where the risk is proven and the option is selected to address it is chosen in order to maintain capacity required for gas being shipped to NSW, the long term interests of consumers is not served if Victorian consumers are liable to pay for any of the extra costs of that option.

Recommendations:

- The AER should examine the case made for the early acquisition of the easement for the WORM to evaluate its merit. If the suggested cost savings are robustly supported and there are firm prospects that the WORM will be constructed by 2025 the AER might consider approving the investment. If there is reasonable doubt then the AER might consider options like allowing a pass through event following a firm decision to construct the WORM.
- The AER should consider engaging an expert to review the APA risk assessments associated with the urban encroachment pipeline protection projects. It should also consider the

[35] APA VTS - D22 - BC230 Encroachment High Consequence Areas - 20161230 – Public p.12

[36] Ibid pp.11-12

appropriateness of the selection of the more expensive slabbing option for the VNI (on the information supplied, seemingly because of the capacity needs for gas to be delivered to NSW) and if appropriate, treat the extra $1.1 million cost as capital to be recovered, over its regulatory life, from shippers exporting gas.

2.3 Expense Classification – Pipeline Inspection

What the business has proposed

APA classifies transmission pipeline inspection costs as a capital expense. Pipeline inspection is carried out to monitor the condition of the pipeline. Where physically possible, inspection uses a tool that is put into the pipeline and moves through it under the pressure of the gas, taking measurements of the condition of the pipeline (depending on the type of tool) and measuring such things as: wall thickness; internal surface quality; and, incidence of corrosion or cracking. The tool used is commonly called a pig and the process is called pigging. Direct inspection, by dig up, is used in some cases, primarily where pigging is not physically possible.

APA carries out pigging on its transmission pipelines using a risk based assessment of when it is required and subject to regular review and specified periods for certain inspections.[37] The applicable Australian Standard (AS2885) requires periodic inspection and the Safety Case for the VTS, approved by Energy Safe Victoria, also requires inspection. APA's minimum position on inspection frequency is as follows:

> *There is a maximum of 10 years between inline inspections unless an engineering assessment has been undertaken suggesting a different timetable.*[38]

Running a pig through a pipeline from time to time to check its integrity could look to a layman like maintenance of the asset. Maintenance is commonly considered to be an operating expense.

During the current Access Arrangement period, APA has undertaken $11.6 million[39] of pigging and rectification of pipe which has not been able to be pigged. In the next Access Arrangement period APA proposes carrying out $28.5 million[40] of pigging and direct pipeline inspection and pipe rectification work of which around $16.6 million is pigging.[41]

APA notes that its pigging expenses are treated differently for different purposes:

> *There are minor differences in approach between the capitalisation of costs for regulatory purposes and tax purposes. While some items of major maintenance activity (for example, pigging) are capitalised and amortised over short periods for regulatory purposes, these items are expensed for tax purposes.*[42]

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[37] APA VTS – SD – APA – National InLine Inspection Policy BC279 - 201202 – Public; Section 4
[38] APA Victorian Transmission System - Access Arrangement submission 3 January 2017 p.77
[39] Ibid p.78
[40] Ibid p.100
[41] APA VTS – D23 – BC257 – 259 Pipeline integrity - 20170103 – Public pp.3-4
[42] Ibid p.213

The capitalisation of pigging (and other unspecified maintenance activities) for regulatory purposes results in these expenses being added to the RAB to earning a return over time instead of being expensed in the year the cost is incurred.

The AER needs to look at pigging and all the other expenses that are treated as capital for regulatory purposes but as operating expenses for tax purposes. Is APA's approach here consistent with other transmission pipelines, and has the AER approved capitalisation for regulatory purposes of these type expenses in other Access Arrangements? How is this inconsistent treatment justified?

Consumer perspectives

If costs which should be considered operating costs are capitalised into the RAB, then the revenue requirement is increased, and consumers will pay more for this work than they should. This is not in the long term interest of consumers.

Recommendation:

- The AER should examine pigging and the other items that APA capitalises for regulatory purpose but treats as operating expenses for tax purposes, including looking at how the same expenses have been treated by other transmission pipeline owners and provided for in their Access Arrangements. If APA's inconsistent treatment is not justified, then these expenses should be treated as operating expenses for regulatory purposes

3. Operating Expenditure

3.1 Corporate Overheads

What the business has proposed

APA VTS is forecasting that its operating expenditure for the current period will be approximately $23.2 million less than the approved expenditure for the period. The following table presents the year by year differences.[43]

Table 8-1 – Comparison of AER Final Decision and actual and estimated operating expenditure for the current access arrangement period ($m nominal)

$m nominal	2013*	2014	2015	2016(e)	2017(f)	Total
AER Forecast	15.1	30.3	32.1	33.7	33.9	**145.1**
Actuals	12.8	26.6	27.2	26.8	28.4	**121.9**
Difference	2.3	3.7	4.9	6.9	5.6	**23.2**

• 2013 is a half year expenditure to match the access arrangement period.

APA VTS explains that the reductions are largely driven by smaller allocations of corporate overheads to the VTS and reduced insurance costs.[44] The allocation of corporate overheads to APA VTS opex has fallen from $12 million in 2012 to an estimated $6.4 million in 2016.[45]

CCP position

We welcome APA's focus on driving cost efficiencies through business synergies, and acknowledge that this will lead to benefits for Victorian gas consumers over the next AA period. While a reduction in corporate overheads is generally a positive outcome leading to a reduced regulated revenue requirement for APA VTS, CCP11 would like to be assured that this reduction in opex overheads is not a reflection of a commensurate increase in the allocation of corporate overheads to capex. We also suggest that the AER should examine the cost allocation methodology proposed by APA VTS to ensure that corporate overhead costs are correctly apportioned to the VNI expansion project assets, and that Victorian gas consumers do not bear some of these costs unnecessarily.

3.2 Step Change – Southbank Lease

What the business has proposed

As part of APA VTS's Dandenong Relocation and Redevelopment Project, APA VTS is proposing a step change totalling $792,000 as the allocated proportion of leasing costs associated with new office space at Southbank.[46] The new accommodation was necessary because of age and maintenance issues at the Dandenong site buildings, as well as space limitations. APA VTS reported that:

[43] APA – Victorian Transmission System Access Arrangement submission, page 195
[44] APA – Victorian Transmission System Access Arrangement submission, page 196
[45] APA – Victorian Transmission System Access Arrangement submission, Table 8-3
[46] APA – Victorian Transmission System Access Arrangement submission, page 203

Given the age of the buildings (over 30 years old), issues are arising with their repair and maintenance and the resulting employee discomfort and increased costs. There are ongoing problems with plumbing, mechanical services and roofing.[47]

CCP position

CCP11 questions whether the Southbank lease is in fact a new business cost, and hence a step change. Costs associated with the operation and maintenance of the previous accommodation at Dandenong will already have been accounted for in APA VTS's base year opex. CCP11 suggests that the Southbank lease cost is simply a substitution for the previous operation and maintenance costs associated with the Dandenong site. In our view, APA VTS has not demonstrated that this is a material new business cost.

3.3 Scope Change – Victorian Northern Interconnect Expansion (VNI)

What the business has proposed

The VNI expansion is expected to be completed in 2018. APA VTS has identified an opex scope change arising from maintenance of the new assets from 2018 onwards. It is foreshadowed that the work would include ongoing maintenance of the pipeline, compressor and easement. Forecast expenditure is $0.3 million per annum.[48]

CCP position

We understand that the primary beneficiaries of the VNI expansion project will be the gas shippers transferring gas into New South Wales and beyond, rather than Victorian gas consumers. We suggest that a careful examination of all costs associated with the VNI is necessary to ensure that costs are allocated against the appropriate tariffs for both the next, and subsequent AA periods.

3.4 Other Allowances

What the business has proposed

APA VTS reports that it maintains two types of inventories related to the VTS:

- An inventory of spare pipes, valves and fittings required for maintenance and emergency use; and
- Passive linepack gas purchased as part of the investment in a new pipeline.[49]

According to the methodology used in preceding access arrangement periods, a return on these assets is included in the allowed revenue. APA VTS proposes to continue this approach.

CCP position

CCP11 considers that it is very likely that a proportion of these inventories are associated with the VNI expansion assets referred to previously. Again we advise that a careful examination of all costs associated with the VNI is necessary, to ensure that costs are allocated against the appropriate tariffs for both the next and subsequent AA periods.

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[47] APA – Victorian Transmission System Access Arrangement submission, page 85
[48] APA - Victorian Transmission System Access Arrangement submission, page 205
[49] APA - Victorian Transmission System Access Arrangement submission, page 208

It is surprising that a large and sophisticated organisation such as APA whose core business is asset management does not maintain an accurate valuation of its spares inventory. Details of how APA VTS arrives at its estimate of the total value of inventory as 0.23 per cent of the VTS regulatory asset base are not provided.[50] We consider that this estimate requires further justification.

Recommendations:

- The AER should review APA VTS corporate overhead allocation methodology, to ensure that corporate overheads are being appropriately allocated between opex and capex, and to the appropriate tariffs.
- The Southbank lease opex step change should be rejected on the basis that it is not a new business obligation, rather a replacement of costs which were previously included in base year opex.
- The AER should ensure that all costs associated with the VNI expansion are allocated to appropriate tariffs, and that Victorian consumers are not paying any more than their fair share of the VNI expansion costs.
- The AER should seek justification of the APA VTS estimate of the valuation of the spares inventory.

4. Rate of Return and Inflation

CCP11 notes that the rate of return issues regarding the return on debt and inflation are matters still before the Courts.

APA has adopted a different approach to the return on debt and the estimation of inflation from that adopted in the AER Guideline. At this stage, CCP11 would prefer to postpone discussion on these until the Court processes are reasonably finalised. The AER is intending to publish a paper on the forecasting of inflation in the near future, and members of CCP11 anticipate participating in that process.

However, the evidence provided to date supports the AER's approach on each of these matters. For example, APA proposes to move straight to the 10 year trailing average for debt. This increases the return on debt from an estimated 4.5 per cent to 7.47 per cent. As argued by the AER to the Tribunal and to the Federal Court, the trailing average without transition provides a significant increase to the allowed return on debt that does not reflect the reasonable efficient cost of debt and, taken as a whole, is not in the long-term interests of consumers. In the more recent appeal by SAPN to a differently constituted Tribunal, the Tribunal accepted this argument.

The proposal to move directly to a 10-year trailing average is not supported by consumers, and CCP11 advises the AER to reject this proposal. The arguments put by the AER to the Tribunals are cogent and are supported.

While consistent with current inflation rates, APA's proposal of an inflation rate of 2.0 per cent is below the longer term forecast by the RBA, and below the RBA's target forecast. If APA's forecast of

[50] APA – Victorian Transmission System Access Arrangement submission, page 209

2.0 per cent was to prevail over the five year regulatory horizon, APA would recover more revenue than would be efficient.

APA has proposed an annual update of inflation (similar to the annual update of the cost of debt). There is some merit in the AER investigating this option as part of its review cited above.

The remainder of this section focuses on the return on equity proposal.

4.1 Return on equity

What the business has proposed – an overview

APA VTS (APA) has proposed a rate of return on equity that is significantly above the rate of return on equity that would be estimated if the AER's Rate of Return Guideline was applied. The APA's proposed return on equity is 8.45 per cent, while a reasonable estimate of a return on equity using the AER's Guideline approach is around 6.6 per cent (depending on the assumed risk free rate).

APA's proposed return on equity of 8.45 per cent is also greater than the return on equity allowed in APA's current Access Arrangement (8.02 per cent), despite the fact that the estimated risk free rate has declined by some 200 basis points. This would suggest there has been a substantial increase in market risk since 2013, which is difficult to justify based on objective measures of current market activity such as the volatility index and the price-earnings ratio.

APA's rate of return on equity proposal will have a material impact on APA's overall revenue allowance, as the return on capital contributes some 59 per cent of APA's proposed revenue requirement.

Table 4.1 below sets out the components of APA's return on equity proposal within the parameters required by the AER's Sharpe-Lintner CAPM (SL CAPM) that the AER has set out in its 2013 Guideline. CCP11 uses the AER's Guideline as a 'frame of reference' given the extensive consultation that has underpinned the Guideline, and given the continued use of that Guideline by the AER in its subsequent electricity and gas determinations.

APA states that it largely follows the AER's Guideline. However, there are three aspects of APA's proposal that vary from the Guideline and which are of particular concern:

- The estimate of the equity beta. APA has used an equity beta of 0.8 where the Guideline proposes an equity beta of 0.7;
- The estimate of the market risk premium (MRP). APA has implied a MRP of 7.76 per cent; and
- The approach APA adopts to assessing the MRP as a 'residual' after estimating the overall market return and the risk free rate. For the purposes of this advice, this question will form part of the response to the second question above on the MRP.

Having considered the APA proposal carefully, the conclusion is that APA has not adequately justified its proposed changes to the AER's Guideline.

Each of these three issues is discussed briefly below along with recommendations for the AER.

The Australian Competition Tribunal has recently reviewed the AER's approach to assessing the Guideline, and determined that the AER has exercised its discretion reasonably. The Tribunal found no error in the AER's approach, and confirmed that the AER had the discretion to determine the weight to apply to any model or other data in determining the value of the return on equity parameters.[51]

Table 4.1: Return on Equity Parameters in the SL CAPM

SL CAPM parameters	AER 2013 Guideline	APA Proposal	Comment
Risk free rate (RFR)	10 year CGS average over 20 BD, prior to determination. AER's recent draft determinations indicate a RFR of around 1.95%	2.24%	APA uses 20 days ending October 2016 and is compliant with AER's Guideline.
Equity beta (β)	Point estimate of 0.7	Point estimate of 0.8	APA claims this figure is based on updated analysis
Market risk premium (MRP)	Point estimate of 6.5% derived from historical data and forward looking estimates	Implied MRP point estimate of 7.76%	APA derives overall return on equity of 10%, with MRP as 'residual' [1]
Return on equity for the equity market as a whole *(E(rM))*	Implied point estimate for the market return on equity of around 8.74%[2] (applying RFR of 2.24% as per APA)	Point estimate of 10.0%	AER's implied estimate given AER's point estimate values for MRP and RFR and equity beta
Risk adjusted return on equity for a gas NSP	Estimate of approx. 6.79% (applying RFR of 2.24% as per APA)	Point estimate of 8.45% [3]	
Equity Risk Premium for investment in a gas NSP	4.25% (applying RFR of 2.24% as per APA estimate	5.52%	

1. In the APA approach, the MRP = (10.0%-2.24% = 7.76%)
2. AER estimate based on RFR plus (equity beta * MRP) = (2.24 + (0.7*6.5) = 8.74%)
3. APA estimate based on RFR + (equity beta * (return on market – RFR) = (2.24 + (0.8 * (10.0-2.24))

The proposed equity beta of 0.8

APA has argued on the basis of a report by Frontier Economics[52] that since 2013, there has been an increase in beta for the benchmark efficient entity (BEE) and that the AER should adjust its Guideline estimate of beta to reflect that fact. APA's arguments are complex but appear to be based on the following logic:

[51] Australian Competition Tribunal, *Applications by the Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompt 1 at 713

[52] Frontier Economics – *An equity beta estimate for Australian energy network businesses*, Report prepared for APA Group, December 2016

- The most recent historical analyses of returns for listed energy network companies suggest an empirical equity beta of 0.7.
- In its Guideline, the AER indicated that the best estimate of the equity beta from its historical analysis of excess returns is 0.5 from a range of 0.4 to 0.7.
- However, AER selected an equity beta at the top of this range, in large part because it took account of the Black CAPM theory that claimed there was a "low beta bias" in the SL CAPM.
- APA agrees that there is a low beta bias in the AER's preferred SL CAPM foundation model.
- Therefore, an additional factor must be added to the updated empirical estimate. A conservative estimate of this factor is 0.1, resulting in a total equity beta of 0.8 (0.7+0.1).
- The Economic Regulatory Authority of Western Australia (ERA) has recently approved an equity beta of 0.7 from a range of 0.479 to 0.870 based on its empirical analysis. ERA arrived at this figure on the basis of its empirical analysis, without regard to "uplift".

There are many limitations to this analysis and these are discussed in greater detail in the additional attachments to CCP11 submission. In brief:

- Frontier's observation of a trend increase was based on 5 years of data on 4 Australian ASX listed network companies. The estimations ranged from 0.65 to 0.72. The AER's beta of 0.7 is within that range.
- Frontier recommended using a 10-year historical analysis as this provided a more reliable estimate given there were only four companies left in the Australian sample and that a more reliable estimate of beta would be made with more data. The 10-year analysis indicted a lower beta range (0.52 – 0.57) that was consistent with the AER's empirical best estimate of the equity beta of 0.5.
- In its 2016 determination, the ERA estimated a beta range of 0.5 to 0.9 using 5 years of data. It did not apply uplift. That is because the ERA is not satisfied that, properly framed, there is no low beta bias and an adjustment to the SL CAPM is required.
- In addition to the ERA's concern with the low beta bias, the theory of the Black CAPM is difficult to put into practice because of the well-known problems with quantifying the adjustment required.
- APA has no clear theoretical or substantive empirical rationale provided to explain the stated increases in the empirically derived equity beta since 2014. In the absence of a robust theory to explain the changes, there is insufficient evidence to require the AER to adjust its equity beta.
- Regulatory consistency is an important principle. There must be a high standard of proof established before the AER changes its Guideline parameters.

APA's proposed MRP of 7.76 per cent

APA's MRP is not directly estimated. It is calculated as the difference between APA's estimation of the market return on equity and the risk free rate. APA claims that in adopting this approach it is not making judgement on the basis of adopting the Wright CAPM. The Wright CAPM is an alternative specification of the SL CAPM that is based on the proposition that the return on market equity is relatively stable so that when the risk free rate rises or falls the market risk premium moves one for one in the opposite direction.

APA states that it first assesses the market return on equity at the time of the proposal using historical excess returns analysis – without assuming that the market return is fixed. APA reports that its best estimate of the market return on equity is 10 per cent (See table 5.1) taking into account the outputs of its Dividend Growth Model (DGM).

Given a risk free rate of 2.24 per cent calculated on the basis of the yield on 10-year Commonwealth Government Securities (CGS), the MRP is 7.76 per cent (10 – 2.24).

APA claims that this estimation of the MRP is to be preferred as it provides a better estimate of the prevailing conditions in the market as required by Rule 87(7) of the National Gas Rules (NGR). APA further states that the AER's approach is 'anchored' in its historical excess returns and is unlikely to provide a forward looking estimate of the MRP.[53]

APA also supports its proposal of a higher MRP by reference to recent decisions by the ERA. The ERA used the Dividend Growth Model to select a range for the MRP of 7.6 per cent to 8.8 per cent. It then considered the range found in its historical excess returns analysis of 5.4 per cent to 8.5 per cent. The ERA then selected a point estimate of the MRP of 7.4 per cent.[54] APA states that the ERA's MRP estimate is "more closely grounded in prevailing market conditions in equity markets than the estimate made by the AER, and better reflects the requirement for a forward looking estimate".[55]

APA also provides evidence that the gap between the historical excess returns analysis and the DGM outputs has grown and there is now no overlap between the two. This raises further questions in their mind about the reliance the AER is placing on the historical excess returns analysis.

Despite the extensive analysis undertaken by APA, it is recommended that the AER not accept the proposed revision of the MRP.

In a previous section we pointed to the importance of regulatory consistency and the need for the AER to be provided with substantive evidence of a need for change in the key parameters and approach set out in the Guideline. It was also noted that the Tribunal has found no issue with the AER's approach and has indicated that the AER is able to use its discretion in considering the appropriate models and other information that best contributes to the overall rate of return objectives.

In addition, the following comments are made in support of the recommendation to the AER not to accept APA's proposed MRP.

- While the AER pays some attention to the DGM, it has also recognised its weaknesses, and the potential for error and/or bias because of the many assumptions that must be made about future dividend growth, GDP growth, inflation and the timing of the 'return to equilibrium'. The AER should therefore carefully consider changes to the MRP based on evidence of the market return as APA uses (or the MRP) derived from the DGM analysis.

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[53] APA VTS – *Revised Access Arrangements Proposal*, 2018-22, p.p. 146 -147

[54] ERA – *Final Decision on Proposed Revisions to the Access Arrangements for the Goldfields Gas Pipeline.* For example, see paragraphs 984 and 1014

[55] APA VTS – *Revised Access Arrangements Proposal*, 2018-22, p.150

- The AER's reliance on the historical excess returns analysis is consistent with the view that the relevant MRP is the premium that investors attach to investment in long-term assets. The other parameters in the AER's framework such as the yield on CGS and commercial bonds are all linked to a 10-year horizon. It is consistent with these parameters that the AER take a long term view of the MRP, albeit it is the view that is prevailing in the current market for these long term investments. As the Tribunal states in confirming the AER's position:[56]

  In the AER's view, the short-term MRP will vary from the long run estimates of MRP at times but that in order to maintain regulatory consistency, a long-term MRP with a notional ten year investments consistent with the term of the risk free rate ought to be considered.

- It is misleading to quote the ERA selctively. The ERA itself reconciled between its preferred MRP and the AER's MRP. It explained that the majority of the difference could be explained by the ERA's use of yield on 5-year CGS bonds while the AER uses the yield on 10-year CGS bonds. The ERA explains this as follows:[57]

  1130: This can be reconciled through the Authority's use of a 5 year term for the risk free rate instead of a 10 year term. The comparable 10-year risk free rate on 31 May 2016 is calculated at 2.32 per cent; 50 basis points higher than that (1.82 per cent) used by the Authority to derive the MRP. This would bring the Authority's MRP estimate down to 6.9 per cent.

  1131: The remaining 40 or so basis points appear to result from differences in the information used by the Authority to arrive at a point estimate within the established range. Differences include the Authority's reliance on forward looking indicators of risk and the economic outlook and the AER reliance on surveys and stakeholder submissions.

  1132: The Authority considers the AER's estimate is comparable to this Final Decision, once differences in parameter estimates and judgement are accounted for.

  …

  1138: As discussed in paragraphs 1086 to 1093, the Authority's estimates are forward looking over the next 5 years and hence can deviate from the long run historical averages implied by mean reversion or the 'Ibbotson' approach. As shown in table 79, ***these estimates tend to be around 6 to 6.5 per cent range****. The Authority notes that this range of estimates coincides with those typically employed by other regulators****. If the Authority were to adopt a longer term view, it would be logical to adopt this range.*** *However, the Authority adopts a 5 year*

[56] Australian Competition Tribunal – *Application by Envestra Limited (No 2*) [2012] ACompT4 @ 136. The AER had proposed a MRP of 6.0 per cent based largely on the historical analysis having also considered other evidence including the DGM. While this decision was made prior to the implementation of the revised NGR and the AER's Guideline, the requirements in the NGR rule 87 still applied, i.e. for the AER to have regard to prevailing conditions in the market for equity funds

[57] ERA – *Final Decision on Proposed Revisions to the Access Arrangements for the Goldfields Gas Pipeline*, 30 June 2016 (as amended 21 July 2016), paragraphs 1130 -1138

risk free rate in the return on equity and correspondingly allows deviation in the MRP from the long run value typically employed by other regulators. [emphasis added]

Consumer Perspectives on APA's Return on Equity

It does not appear that APA has consulted with consumers regarding its decision to vary from the AER's Guideline parameters with respect to the equity beta or the MRP.

R*ecommendations*:

Regarding the Equity Beta

- The AER should not accept APA's proposal for an increase in the equity beta.
- The AER could investigate further the claim that there has been a change in the equity beta for a BEE since 2014 based on the 5-year analysis. The 10-year analysis by Frontier suggests that a longer-term perspective such as that adopted by the AER is more relevant and reliable. The range and point estimates in the AER's Guideline are consistent with this longer-term analysis.
- The AER should consider the views of the ERA with respect to the Black CAPM.

Regarding the MRP

- The AER should not accept APA's proposal for an increase in the MRP.
- The AER could investigate further the claim that there has been a change in the dividend growth model outputs in recent years and whether this change represents a permanent change in the market environment or it reflects short term sentiment in the market.
- The AER's SL CAPM takes a longer view on the MRP than other regulators. Given the AER's SL CAPM is built around a 10-year regulatory horizon, the longer term view is appropriate. The AER might investigate whether it should just rely on historical excess returns and whether the DGM remains a useful tool to capture this longer term view.
- The 10-year analysis by Frontier suggests that a longer-term perspective such as that adopted by the AER is more relevant and reliable. The range and point estimates in the AER's Guideline are consistent with this longer-term analysis.
- The AER should consider the views of the ERA with respect to the Black CAPM.

5. Tariffs

CCP11 wishes to comment on the following two aspects of APA VTS' tariff proposals:

- APA VTS' 'cap and collar' proposal; and
- Cost recovery of the significant expansion of the RAB and additional opex and depreciation.

APA VTS' 'cap and collar' proposal

APA VTS is considering reinstating a 'cap and collar' mechanism that was in place in a previous regulatory period, to cover demand uncertainty. This will affect tariffs charged to retailers and ultimately to consumers.

It is the view of CCP11 that the fact that this arrangement was previously in place should not mean that there is only limited consideration of the appropriateness of this mechanism in the Access Arrangement for the forthcoming regulatory period. It was not in place in the current period. If APA does propose to reinstate a 'cap and collar' mechanism, the AER should determine what has changed that merits a change to implement the mechanism in the coming period when it is not in place in the current period.

The concern of CCP11 largely relates to consideration of assignment of risk between APA VTS and Victorian gas consumers. Risks should lie where they are best managed.

CCP11 views with concern the suggestion that a revised proposal from a network business might introduce new issues. The revised proposal should address the AER's draft decision, and not bring new proposals on which stakeholders have not previously had the opportunity to provide submissions.

Recommendation

- If APA does propose to reinstate a 'cap and collar' mechanism, the AER should consider what risks might arise for Victorian gas consumers if the mechanism were to be approved, and whether it is appropriate for the consumers to bear those risks.

Cost recovery of the significant expansion of the RAB and additional opex and depreciation
This issue is important because tariffs should be set based on the principle of 'user pays'.

APA VTS has undertaken significant expansion of its regulated assets, the SWP and VNI, to allow for substantially greater capacity for export of gas from Victoria into New South Wales. This expansion is not intended to benefit Victorian gas consumers. As discussed in our advice on capital expenditure (section 2 of this paper), the magnitude of the investment would not be justified if the sole purpose of the expansion was to benefit Victorian consumers of gas. Rather, the beneficiaries of the expansion are the interstate shippers of gas from Victoria into New South Wales.

We understand that APA VTS is proposing substantial increase in the withdrawal tariff at Culcairn to recover its additional costs, so that the interstate shippers pay the full costs of the expansion that benefits them, and none of these costs are levied on retailers in respect of serving Victorian gas consumption.

CCP11 endorses the approach that Victorian gas consumers should not bear any of the costs associated with expenditure to benefit interstate shippers of gas from Victoria into New South Wales.

Any additional capex that finds its way into the APA VTS RAB will be included in the depreciation building block in determining the total revenue that APA VTS should be able to recover in the coming regulatory period and in future regulatory periods. Opex will be recovered through the opex building block.

CCP11 advises the AER to analyse the tariff proposals for the coming regulatory period to ensure that all capex (depreciation) and opex associated with expenditure to benefit interstate shippers of gas from Victoria into New South Wales is recovered solely through the withdrawal tariff at Culcairn, and not through any tariff related to serving Victorian gas customers.

CCP11 is concerned that any expenditure to benefit interstate shippers of gas from Victoria into New South Wales that is approved by the AER remains segregated from other expenditure, so that in future regulatory periods it will again be possible to ensure that these costs are recovered solely through the withdrawal tariff at Culcairn, and not through any tariff related to serving Victorian gas customers.

The concern of CCP11 is enhanced because there may be uncertainty of volumes that will flow through Culcairn from Victoria to New South Wales. If the expected volumes do not materialise or are not sustained, APA VTS may find difficulty recovering full costs through the volumes of gas that are withdrawn at Culcairn, and may in future seek to recover at least some of the costs from Victorian consumers.
Further discussion of this matter is to be found in section 2 of this advice.

Recommendation

- The AER should ensure that the arrangements put in place in this regulatory determination fully quarantine all the costs associated with expenditure to benefit interstate shippers of gas from Victoria into New South Wales with separate accounting and reporting. This should be coupled also with ensuring that it is in accordance with the National Gas Rules to disallow recovery of these quarantined costs from Victorian consumers.

6. Access Arrangement

6.1 Cost pass through

What the business has proposed

APA VTS has proposed that a new cost pass through be added to the Access Arrangement (section 4.6 "Reference Tariff Variation Mechanism") for "a new gas market structure development event". This pass though is sought recognising that the AEMC has recommended substantial changes to the structure of the Victorian gas market. If this recommendation is adopted by governments, there will be a major project in developing the detail of the market structure, drafting legislation and rules, and preparing systems and processes for compliance with the new requirements.

The definition of the proposed "new gas market structure development event" is:[58]

> *…as [sic] event whereby:*
>
> *a. a decision is made to develop and/or implement a new gas market structure in Victoria; and*

[58] VTS Access Arrangement 3 January 2017 p.20

b. *Service Provider incurs costs in developing and/or implementing systems, processes and procedures made necessary by the decision to develop and/or implement a new gas market structure.*

Costs to be passed through are limited to prudent and efficient costs for the development and/or implementation of systems, processes and procedures made necessary by the decision to develop and/or implement a new gas market structure in Victoria.

APA proposes that the new gas markets cost pass through, like all existing cost pass through events (except, it is proposed, the newly defined carbon cost event), be subject to a materiality test set out in the Access Arrangement which permits the pass through where:

> *"…that event is reasonably expected to have an impact of one per cent of the smoothed forecast revenue specified in the Access Arrangement Information, in the years of the Access Arrangement Period that the costs are incurred"*[59]

NSPs are required to advise the AER of a proposed cost pass through prior to implementation. The AER must approve a proposed cost pass through if it satisfies the Access Arrangement's requirements.

APA foreshadows that it is likely to be required to invest in new systems and new procedures if the market changes are implemented. APA sees that the process for development of the new market structure is likely to be drawn out over several years during which, as the service provider of the transmission system, it will need to be actively involved, including through representation on working groups and panels.

The definition for the new gas market structure development event is wide. It is triggered from when a "decision is made to develop" a new market structure. Once across this threshold, all costs associated with "developing" systems, processes and procedures are captured. This appears to include involvement in working groups and panels and APA lobbying for its interests in the process. If through this development process it is determined not to proceed with the new market, the cost would appear still to be passed through.

NSPs are routinely involved in panels, working groups and lobbying across and the whole range of their businesses including matters like market and rule changes, development of technical standards, health and safety, and industry representative bodies. These are typically business as usual operating expenses. In this vein, the APA's expenses in the development of a new market would appear to be operating expenses. Once the market is defined and there are new and legally binding obligations which APA must prepare to comply with, there are firm and legitimate additional expenses in supplying the reference services which APA is entitled to recover. The existing regulatory pass through event in APA's Access Arrangement provides a proven and predicable mechanism (common to all Access Arrangements) for APA to seek recovery of these costs and for the AER to assess the legitimacy of the recovery sought.

APA VTS has also proposes retaining a cost pass though event for a "carbon cost event" amending the existing definition of "carbon cost event" to remove the specific reference to the Clean Energy

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[59] APA Victorian Transmission System - Access Arrangement submission 3 January 2017 p.22

Act 2011 (Cth). The following is the proposed definition with changes from the current Access Arrangement shown:

> *"An event that occurs if, for a given Regulatory Year of the Access Arrangement Period, the Service Provider becomes liable for a carbon cost (part of which may be an estimate) in complying with a mechanism that is designed or intended to reduce or manage carbon emissions, or to otherwise reduce or manage greenhouse gas emissions. ~~the carbon pricing mechanism established under the Clean Energy Act 2011 (Cth) and associated legislation relating to the management of greenhouse gas for that Regulatory Year.~~ The carbon cost event is taken to have occurred at the time liability for carbon costs is established. Actual carbon costs and associated revenues are to be reconciled at the time that it is possible for Service Provider to calculate the carbon costs it has incurred for a Regulatory Year without use of estimation."*[60]

The result of changing this definition, which is currently clearly focused on cost arising from the now defunct Clean Energy Act, is to provide a much wider definition of what might be a pass though in this instance. It is also proposed that this event not be subject to the materiality trigger.

This imprecise and unproven pass through does not appear necessary as there are the existing tax change event and the regulatory change event (both common to NSPs' Access Arrangements and well understood), which are likely to apply should government policy change to impose any meaningful form of carbon pricing.

Consumer perspectives

Cost pass through events leave open a window for the revenue requirement of an NSP to increase unpredictably during the term of an Access Arrangement. A pass through event and its costs cannot receive the same scrutiny and consumer consultation as all other costs that are approved through the Access Arrangement review. Therefore, it is preferable that pass through events be kept to a limited range of proven and predictable definitions which apply across NSPs, have precedents of application and are familiar to the AER. Similarly, all cost pass through events should be subject to some materiality trigger. This approach to pass through events is most likely to provide the best outcome for consumers on a cost on which they will not be consulted.

The widely defined proposed new gas market structure development event appears to provide for what might be considered operating costs, to be recovered. There appears to be room for some debate as to what costs APA could include. The risk for APA should be covered by the existing regulatory change event. In these circumstances, approval of this pass through would not be in the interests of consumers.

The redefined carbon cost event moves from referencing costs arising under specified legislation to costs arising for a much wider range of possible events. The uncertainty associated with the proposed definition is not in the interests of consumers and the risk for APA should be covered by the existing regulatory change or tax change events.

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[60] VTS – Access Arrangement 3 January 2017 p.17

Further, consumers are likely to be best served by there being a limited range of common pass through events which have a well understood scope and which the AER is experienced in applying.

Recommendations:

- The AER should assess whether the proposed definition of new gas market structure development event could include costs that it might typically consider operating expenses and whether the legitimate concerns of APA are addressed under the existing regulatory change pass through event.
- The AER should not accept amendment to, or continuation of, the definition of carbon cost event in APA's Access Arrangement if it is satisfied that APA's legitimate concerns are covered by other existing pass through events.

CONCLUSION

There are several areas where CCP11 is concerned that the proposal from the NSP may not be in the long term interests of consumers.

The review of the NSP's consumer engagement and consideration of issues that may not be in the long term interests of consumers, with CCP11's recommendations regarding these, are concisely summarised in the Executive Summary above.

CCP11 commends to the AER the issues raised in this advice and the recommendations made.

Deemed Signed

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Chris Fitz-Nead	Bev Hughson	David Prins	Robyn Robinson
Sub-panel Chairperson			