Jemena

Jemena Gas Networks
(NSW) Ltd
ABN 87 003 004 322

Axxess Park
321 Ferntree Gully Road
Mount Waverley VIC 3149

T +61 3 8544 9000
F +61 3 8544 9888
www.jemena.com.au

19 March 2010

Email: NSWACTgas@aer.gov.au

Mr Steve Edwell
Chair
Australian Energy Regulator
Level 7, Angel Place
123 Pitt Street
Sydney NSW 2000

Attention: Mr Mike Buckley, General Manager, Network Regulation North

JGN access arrangement revision: Revised proposal

Dear Mr Edwell

Jemena Gas Networks (NSW) Limited (**JGN**) is pleased to submit its revised access arrangement revision proposal for its network to the Australian Energy Regulator (**AER**) in accordance with the national gas rules.

The enclosed proposal package includes:

- the Managing Director statutory declaration
- the revised access arrangement revision
- the revised access arrangement information
- the revised reference service agreement terms and conditions
- the regulatory models.

This proposal package also comprises JGN's interim response to the AER's draft decision.

In the Attachment to this letter I have include an overview of the key issues for our access arrangement revision and I commend them to you.

In accordance with rule 43(2) of the national gas rules, JGN has identified the information in its submission that is confidential. Accordingly, we request that the AER maintain the confidentiality of this information.

JGN wishes to continue to engage constructively with the AER in the lead up to its final decision. We are grateful that the AER has allowed JGN longer than 15 business days (the minimum required by the national gas rules) to provide its revised access arrangement revision. The time that the AER has allowed has still been very tight given the number of matters raised in the access arrangement draft decision. In the time available, JGN has used its best endeavours to ascertain the AER's requirements and to respond comprehensively.

We believe that open communication between us is essential if the AER is to be adequately informed and to avoid any misconceptions. This is particularly the case given the complexity of the issues, and that this is the first time the AER has conducted an access arrangement review for JGN or any large gas distribution. Accordingly, I encourage the AER to seek from JGN staff any clarifications or elaborations that are necessary. Our staff are standing by to assist.

We look forward to working with the AER towards a final revised access arrangement.

If you wish to discuss the submission please contact Sandra Gamble, Group Manager Regulatory on (02) 9270 4512 or by email at sandra.gamble@jemena.com.au.

Yours sincerely

Paul Adams
Managing Director

Overview

On 25 August 2009 Jemena Gas Networks (NSW) Ltd (JGN) submitted to the AER its original access arrangement revision proposal for the JGN network for the next access arrangement (AA) period. On 10 February 2010 the AER issued its draft decision. This document sets out JGN's initial response to the AER's views in its draft decision and the ways in which JGN has amended its proposed access arrangement revision.

Significance and challenges of this review

This is the first AA review that the AER has undertaken for a large gas distribution business and the first review JGN has participated in under the new National Gas Law (NGL) and National Gas Rules (NGR). All participating parties—JGN, the AER and stakeholders—are meeting the challenges of dealing with this new regime. JGN is actively engaging with the AER and stakeholders to foster a common understanding of the complex issues surrounding its AA review and the issues raised by the draft decision.

JGN's commercial offering

JGN's access arrangement is its commercial offering to users and reflects its business direction for the next AA period. JGN has considered the AER's draft decision carefully and the reasons that the AER has provided for its preferred amendments in the light of the NGR and the NGL and what is in the best long term interests of its users and customers. Accordingly, it has incorporated some of the AER's amendments and not others. This document sets out JGN's reasoning.

Major need for new capital expenditure

On the basis of extensive analysis and risk assessment, JGN's network remains in significant need of increased investment in system reinforcement, refurbishment and replacement to mitigate capacity constraints, maintain reliability of supply and meet new customer demand. Many of its network and non-network assets are reaching the end of their lives. Wilson Cook, the AER's consultant, examined JGN's analysis and agreed that its proposed capital program for the next AA period was reasonable in scope and in timing. However, the capital expenditure allowance in the draft decision is not sufficient to meet these needs, even making an extreme assumption of no real change in unit costs between the periods.

In the light of JGN's revised demand and inflation forecast and better escalation and cost estimates, JGN's forecast capital expenditure is $891 million.

In and with this document, JGN elaborates on its comprehensive planning, design, estimating and staged approvals process, and provides business case detail and its capitalisation policy. This will provide the AER with the information necessary for it to understand that JGN's forecast costs do reflect that which would be incurred by a prudent service provider acting efficiently in accordance with accepted good industry practice to achieve the lowest sustainable cost. It will also confirm that JGN's forecast capital expenditure relates to projects that are capital in nature.

Weighted average cost of capital

The commercial viability of new investment is largely dependent upon the return on capital JGN is allowed in its AA and JGN proposes a nominal vanilla WACC of 10.86%.

In this revised AA proposal, JGN's cost of capital calculation incorporates many of the AER's amendments, including moving to a post-tax nominal WACC, revised market risk premium and gearing ratio, and inflation forecasts based on reserve bank targets.

JGN has retained the Fama French model in its calculation of cost of equity because, not only is it well accepted, but more importantly it provides a demonstrably better estimate than the capital asset pricing model.

JGN's proposed cost of debt reflects the risks of an efficient gas distributor and the prevailing market conditions. JGN has built on recent work to identify the best estimate of the debt risk premium from available data service providers and puts forward a new methodology that incorporates a number of robust tests. One key element of the methodology is to test the appropriate extrapolation of observed yields. Gas distributors are inherently more risky businesses than electricity distributors and JGN provides further conceptual and empirical evidence to demonstrate this.

JGN reaffirms that 0.2 is the best estimate of gamma on a reasonable basis in the current circumstances. It responds to the AER's criticism of recent studies and submits new evidence in support of its view.

Operating expenditure

The AER and JGN accept that the base year roll forward approach is the best basis for forecasting most operating expenditure that complies with the NGL and NGR. JGN and the AER differ on the approach to establish the efficient base-year cost base, which is the starting point. As the revealed cost method has significant advantages, JGN again uses that as the basis of the majority of its forecast.

The asset management agreement that JGN has struck with Jemena Asset Management (JAM) provides substantial benefits to JGN, its users and its customers in terms of both price and service. In this document, JGN puts forward both an assessment framework and its application to confirm that the price JGN will pay, and the service it will receive, is the best it could achieve.

Significant new evidence that JGN brings forward to support its operating expenditure forecast includes an external validation of its actual costs, more detail to substantiate its step changes, and better escalation estimates.

The benchmarking of JGN continues to show that its costs compare very favourably with its peers. This may in part reflect the significant economies of scale and scope from which JGN is able to benefit through outsourcing to JAM.

JGN's new and legacy services

In its draft decision, the AER agreed that JGN's new haulage and meter data reference services are likely to be sought be a significant part of the market and meet the requirements in the rules.

JGN has now removed its existing reference (legacy) services from its AA because they cannot be sustained with the short term trading market (STTM) scheduled to commence on 4 June 2010.

Demand forecasts

The AER's consultant, ACIL Tasman, confirmed that the methodology used to determine JGN's demand forecast is sound. JGN has now updated its forecast, and has specifically taken account of energy policies that will come into effect in the future.

Regulatory innovations

JGN continues to include in its AA some important regulatory innovations designed to provide real benefits to users and customers.

There are presently 600,000 homes and businesses within JGN's distribution area that have no reticulated gas supply. JGN's market incentive mechanism will significantly increase the likelihood of gas being available to a proportion of those homes and businesses over time, when otherwise they would remain without supply.

JGN's W factor is intended to adjust prices to compensate for the effects on demand of weather cooler or warmer than normal. It is a simple and symmetrical mechanism to smooth the impact of weather on revenue, to some extent, for both customers and JGN—weather being a factor over which neither has control.

Extension of AER's powers

The AER already has extensive powers to gather information and to approve access arrangements in a new regulatory regime carefully designed by policy makers in consultation with industry. JGN has not established in its AA additional new powers for the AER to gather information and require JGN to justify its expansions and extensions during the AA period because this is neither necessary nor appropriate from a regulatory policy perspective.