

# Technical Report: Response to JGN Revised Access Arrangement Proposal – 2020-25



Prepared by



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## 1. EXECUTIVE SUMMARY

TRAC Partners (**TRAC**) has been asked by Energy Consumers Australia (**ECA**) to provide expert regulatory advice on Jemena Gas Networks' (**JGN**) revised access arrangement proposal for the 2020-25 period which was submitted to the Australian Energy Regulator (**AER**) in January 2020 (**Revised AA Proposal**) in response to the AER's Draft Decision (**AER DD**).

This report will assist the ECA's submission on JGN's Revised AA Proposal and the AER DD. It follows a report TRAC prepared for the ECA in August 2019 which reviewed JGN's original access arrangement proposal submitted to the AER in June 2019 (**Original AA Proposal**<sup>1</sup>).

The ECA has asked TRAC whether JGN's Revised AA Proposal, when considered in its entirety, is capable of acceptance by the AER. In particular, TRAC has been asked to:

- identify material evidence gaps in the Revised AA Proposal, particularly in relation to the matters we raised in connection with JGN's original AA Proposal;
- consider whether JGN's Revised AA Proposal reflects the long-term interests of NSW gas customers with respect to price and quality of services, both in terms of the overall proposal and in respect of each of the elements used to determine the reference tariffs; and
- respond to the aspects of the AER DD where the AER DD has requested further information to enable the AER to reach a settled position in the final decision.

In so doing, TRAC has reviewed the Revised AA Proposal, the AER DD and JGN's supporting documentation submitted together with the Revised AA Proposal.

In the time allowed, we have only focused on the more substantive aspects of the Revised AA Proposal and the AER DD. Silence on other aspects of the Revised AA Proposal in this report should not be construed as support for these aspects.

### Relevance of JGN's Consumer Engagement Approach

Before commenting on the above matters, this report responds to an overarching submission made by JGN which is relevant to a number of elements of JGN's Revised AA Proposal. It deals with the way in which the AER's DD addressed outcomes from JGN's customer engagement process that informed JGN's Original AA Proposal and its Revised AA Proposal.

The JGN Revised AA Proposal maintains the positions it set out in its Original AA Proposal on matters which JGN contends reflect what customers have voted on to be included in the AA Proposal. In so doing, JGN believes that its Revised AA Proposal will better meet JGN's customers' expectations and the long-term interests of customers, because it specifically incorporates the feedback that they provided to JGN.

TRAC believes that there are issues in relying on this logic. Furthermore, it could create a novel precedent and possibly marginalise the important role to be played by the AER in assessing access arrangement proposals in accordance with the National Gas Law (**NGL**).

Instead, TRAC's view is that the consumer engagement undertaken by JGN should be put into its proper context having regard to the statutory framework that is to be applied by the AER in assessing

<sup>1</sup> While JGN's Original AA Proposal was submitted in June 2019, the AER DD is based on amendments to the Original AA Proposal submitted by JGN to the AER in October 2019, which ECA was not asked to comment on prior to the AER DD.

proposals - it is an important consideration in assessing what is in the consumers' long term interests but it is only one of many considerations that must be taken into account by the AER under the NGL.

### **Extent to which JGN's Revised AA Proposal is in Consumer's Long-Term Interests**

We note that the AER DD, if implemented at the time of the decision, would result in a 7.9% reduction in allowable revenue compared with JGN's Original AA Proposal. The most significant driver of the reduction is in relation to the rate of return (primarily because of changes in the market variable elements whose values have reduced since JGN's filing rather than because of a disagreement in methodology or approach).

JGN contends that its Revised AA Proposal will deliver network bill decreases of 15% over the 2020-25 period, or \$202 for a typical residential coastal customer. Together with the return of the revenue over-recovery from the 2015-20 period, JGN contends this will further lower bills – according to JGN, the network component of a typical residential bill will reduce by 21%, or \$292.

We agree with the positions adopted by JGN in its Revised AA Proposal in relation to the following elements and believe that they are capable of acceptance by the AER in the final decision:

- The level of actual capital expenditure incurred for the 2015-20 period (including for 2014-15), subject to the AER reviewing the detailed information provided by JGN supporting the level of actual expenditure.
- The approach to establishing the opening capital base for 1 July 2020.
- The methodology for determining the rate of return, subject to its approach on inflation. In this regard, we believe that any changes to the methodology for estimating elements of the rate of return should be undertaken as part of the rate of return guidelines review process and not as part of an individual business' access arrangement approvals process. This is explored further in section 6 of this submission.
- The approach to the estimation of the forecast of operating expenditure. We note that JGN's forecast was updated after JGN submitted its Original AA Proposal (in October 2019, JGN updated its forecast to use 2017/18 operating expenditure levels as the efficient base year (as opposed to the 2018/19 levels) and to change the amount allowed for "movement in provisions"). While we did not have an ability to comment on these changes prior to the AER DD, we believe that these changes are appropriate because they represent a more accurate basis for estimation. We also note that, in relation to the approach to the forecast input price growth rate, JGN has not adopted the approach followed by the AER in the AER DD. Notwithstanding this, we support the JGN approach for the reasons outlined in section 5.
- The CESS mechanism, in particular the use of internal targets for each of the measures used in the contingent payment index.

Notwithstanding this, we believe that there are still a number of key aspects of JGN's Revised AA Proposal which require amendment or further consideration by the AER before we would recommend it being accepted by ECA as being in the long-term interests of consumers and consistent with achieving the National Gas Objective. This is because of the reasons outlined in this report. The areas of the Revised AA Proposal which we believe require amendment or further consideration by the AER are included in Table 1, which summarises the key building blocks of the Revised AA Proposal.

### **Topics where the AER has requested further information**

The AER DD outlines a number of aspects of JGN's original AA Proposal where further information is required to enable the AER to make its final decision. TRAC's position on the adequacy of the

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further information provided by JGN in support of each element of its Revised AA Proposal is as follows:

- in relation to the further information for certain aspects of actual and forecast capital expenditure, see TRAC's comments in section 4.
- The alternative smoothed revenue path methodology proposed by the AER for the 5-year period – see TRAC's comments in section 7.
- In relation to the CESS proposal, further rationale is required to be provided for the proposed range of the targets to be used for each measure used in the contingent payment index. In particular, why that range should not be 90–100 for each measure – TRAC supports the position outlined by JGN in its Revised AA Proposal.

**Table 1: Key aspects of JGN's Revised AA Proposal**

Element of Revised AA Proposal	Capable of Acceptance	Materiality	Key Findings
Depreciation of new investments	No	\$22m	While TRAC supports the shortening of certain asset classes, it does not believe that the case has been made for the shortening the lives of pipeline related asset classes. The recent announcement by the Prime Minister on facilitating investment in gas to ensure gas demand increases as the economy transitions to a lower carbon footprint is important evidence to indicate that there is no increased risk in stranding of assets. See section 3.
Rate of Return	Largely, yes	\$133.2m less than what JGN initially proposed	While JGN adopted the AER's methodology, the values for key elements adopted by the AER in the DD differ from the Original AA Proposal because updated market data and a different inflation assumption are used by the AER. There are some issues associated with debt raising costs and inflation which are better dealt with in the rate of return guidelines than in this approvals process. This is discussed in section 6.
Actual Capital Expenditure 2014-20	Yes	Capitalized overheads (\$28.9m) Other capex for property (\$15.8m)	We note that the further information provided by JGN to substantiate the capital expenditure associated with property and the capitalisation of overheads is of the level of detail we would expect to enable the AER to accept the expenditure as complying capital expenditure – ie a business case, tender information and an independent report substantiating cost allocation. However, we would still expect the AER to review the detailed information provided by JGN supporting the level of actual expenditure
Forecast Operating Expenditure	Largely, yes	\$23.8m less than the Original AA Proposal	The approach in relation to the forecast input price growth rate is dealt with in section 5.

Element of Revised AA Proposal	Capable of Acceptance	Materiality	Key Findings
Forecast Capital Expenditure	Partly	\$108.4m less than was proposed in the Original AA Proposal	See section 4.
Smoothing of Revenue during AA period	Partly	N/A	See section 7

## 2. RELEVANCE OF CONSUMER ENGAGEMENT

Before commenting on specific elements of JGN's Revised AA Proposal, this report responds to an overarching submission made by JGN which:

- deals with the way in which the AER's DD addressed outcomes from JGN's customer engagement process that informed its original AA Proposal and its Revised AA Proposal; and
- is relevant to a number of elements of JGN's Revised AA Proposal.

JGN claims that many elements of its original AA Proposal and its Revised AA Proposal reflect the outcomes of direct customer engagement. The AER DD does not accept some of these elements of the JGN original AA Proposal.

JGN also claims that the aspects of the AER DD which do not accept these elements undermine customer's trust and belief in the legitimacy of the regulatory approvals process and will weaken incentives for both networks and customers to engage in future access arrangement review processes.

Accordingly, the JGN Revised AA Proposal maintains the positions it set out in its original AA Proposal on matters which JGN contends reflect what customers have voted on to be included in the AA Proposal. In so doing, JGN believes that its Revised AA Proposal will better meet JGN's customers' expectations and the long-term interests of customers, because it specifically incorporates the feedback that they provided to JGN.

TRAC has a number of comments on this logic:

- Firstly, the NGL and National Gas Rules (**NGR**) require that there are specific factors that the AER must consider when performing its statutory function of assessing an AA Proposal (for example, the National Gas Objective and the Revenue and Pricing Principles, among other factors). The AER cannot acquit itself of its statutory function solely by relying on the service provider claiming that its AA Proposal is a direct reflection of customers' preferences.
- Secondly, while the customer engagement undertaken by JGN in the lead up to its original AA Proposal is important in understanding what might be in the long-term interests of consumers, the direct outcomes from that engagement process should not, in themselves, be taken as a proxy for what are the consumers' long-term interests. As ECA mentioned in its submission to the AER in response to JGN's original AA Proposal<sup>2</sup>, there are a number of matters relevant to determining what is in the consumers' long-term interest. That this is the correct position seems to have been recognised by the AER in the AER DD.
- Thirdly, for many of the elements of the JGN Revised AA Proposal that JGN claim directly reflect the outcomes of its customer engagement process, the engagement involved the use of high-level principles and hypothetical examples each of which rely on the adoption of many assumptions. An example of this is with respect to adopting shorter asset lives for new investments in certain asset classes. Based on the information disclosed by JGN to the AER and which summarises the customer engagement process, only high level assumptions were provided to customers. Furthermore, it is not clear from the information what explanation was given in the customer engagement process to the linkages that these assumptions would have to the information likely to be included in the actual access arrangement, particularly the real implications on total revenue and reference tariffs.

In light of this, the consumer engagement undertaken by JGN should be put into its proper context having regard to the statutory framework that is to be applied by the AER in assessing proposals - it is an important consideration in assessing what is in the consumers' long term interests but it is only one of many considerations that must be taken into account by the AER under the NGL.

<sup>2</sup> See [ECA's submission to the AER, filed in August 2019, page 9](#)



### 3. DEPRECIATION OF NEW INVESTMENTS

#### AER Draft Decision

In the AER DD, the AER has partly allowed JGN's proposal in its Original AA Proposal to shorten of the lives of some asset classes for the purposes of depreciating future capital expenditure in relation to these asset classes. However, it did not agree to shorten the lives of pipeline related asset classes for the purposes of depreciating the associated future capital expenditure. The level of expenditure in connection with these asset classes represents about 81% of the forecast capex that was proposed for the 2020-25 period in the Original AA Proposal.

The AER responded to the 3 key factors primarily relied on by JGN to substantiate its claim of reduced economic lives for the JGN network and therefore to justify the shortening of the lives for the 9 asset classes as follows:

- Short term declining gas utilization trend

There is insufficient evidence to say that the forecast short term declining gas usage trend will result in the utilisation of JGN's network significantly declining such that it warrants a reduction in the expected economic life of JGN's assets

- Forecast gas supply shortfalls

There is insufficient evidence to say that the AEMO's forecast gas supply shortfall will result in the utilisation of JGN's network significantly declining such that it warrants a reduction in the expected economic life of JGN's assets

- NSW government's planned 2050 carbon neutral target

There is insufficient evidence to say that the NSW Government's planned 2050 carbon neutral target will result in the utilisation of JGN's network significantly declining such that it warrants a reduction in the expected economic life of JGN's assets. It is speculative at this point in time and has not been adequately established by evidence-based forecasts.

While the AER noted that JGN had undertaken significant customer engagement on depreciation and that most customers supported JGN's proposal, the AER noted in the AER DD that JGN's Original AA Proposal to reduce the standard asset lives rests substantially on forecasts as to likely future outcomes. In this regard, the AER reiterates the requirement of the NGR that forecasts must be arrived at on a reasonable basis, and must represent the best forecast or estimate possible. The AER concluded that the case hasn't been made about increased uncertainty in gas usage forecasts and any associated stranded asset risk to warrant a shortening of the economic lives of these asset classes.

The AER also noted that outcomes from JGN's customer engagement program do not remove the AER's obligation to decide these matters on the basis of evidence, using the best forecasts available to the AER.

#### JGN's Revised AA Proposal

JGN's Revised AA Proposal has accepted the AER DD to allow shortened asset lives for the purposes of depreciating new investments in metering assets classes but has retained its original position to shorten asset lives for the purposes of depreciating new investments in pipeline related asset classes.

The key justifications relied on by JGN for this approach is as follows:

- It does not consider in any detail the preferences expressed by its customers on this topic—its customers strongly supported JGN taking these actions and they recognised the benefits to future customers. In the case of JGN's asset lives proposal, they were aware of the marginal reduction in short-term price savings needed to make this possible.
- It does not recognise that this change is required to ensure that JGN's efficient investment incentives are preserved during the 2020-25 period—the task here is to adopt standard asset lives that provide JGN with the correct investment incentive as JGN invests capex during the 2020-25 AA period. The AER's decision must ensure JGN has a reasonable expectation of recovering its costs and a normal return during that period.
- It does not recognise that JGN's proposal is exactly what the gas law and depreciation criteria rules intend the regulated depreciation allowance to do, and what good regulatory practice and precedent support.
- The AER's reasoning is inconsistent in that on the one hand, the AER argues that the reduction in economic lives of JGN's assets is speculative at this point in time, but, on the other hand, the AER also relies on the highly speculative assumption that hydrogen 'could have a substantial positive impact on the future of gas distribution networks' in rejecting JGN's proposal.
- It does not recognise that JGN cannot wait to act, or that there is little downside to acting early—it is difficult to believe that an objective observer could conclude that there was no material risk of asset stranding from the material presented.
- Does not recognise that JGN's proposal seeks a profile of cost recovery that supports lower gas prices in the future when everyone expects JGN's customers to be facing higher costs across the gas supply chain—there is no argument about whether decarbonisation policies will have an impact on gas prices, the debate is about the timing of the impact or about the best ways of mitigating.

## TRAC's Submissions

We to each of these justifications in turn below:

**Customer preferences** - see our comments in section 2 of this report.

**Ensures efficient investment incentives are preserved** – we note that on 31 January 2020, the Prime Minister of Australia announced<sup>3</sup> that a bilateral agreement had been reached with the NSW Government to commit to a number of initiatives that will (among other things):

- increase gas and electricity supply in NSW by encouraging investment; and
- support emissions reduction projects that deliver genuine abatement.

In particular, the initiatives include commitments from the NSW Government to facilitate investment opportunities to inject an additional 70PJ pa of gas into the east coast gas market.

The announcement specifically links the achieving a reduction in emissions to increasing the use of gas as a transition fuel.

We also note that In Australia's Chief Scientist's National Press Club Address: The orderly transition to the electric planet, Dr Alan Finkel supported the Prime Minister's reference to gas as a fuel of transition and referred to hydrogen as the "hero". Dr Finkel said that this transition would take decades and that "It will also require respectful planning and re-training to ensure affected individuals and communities, who have

<sup>3</sup> See <https://www.pm.gov.au/media/nsw-energy-deal-reduce-power-prices-and-emissions>

fueled our energy progress for generations, are supported throughout the transition”.<sup>4</sup> There seems to be a growing recognition that the move to renewable energy sources (such as hydrogen) will require the continued use of gas and that this transition will take decades to occur. And even so, gas will have a continuing role to play.

When coupled with the progress on an LNG re-gasification off-loading facility at Port Kembla, there is growing evidence to rebut the suggestions that there will be:

- a continuation of a declining gas utilization trend
- forecast gas supply shortfalls; and
- reduced gas usage because of the NSW government's planned 2050 carbon neutral target.

**JGN's proposal supports lower gas prices in the future** – the Prime Minister's announcement has, at its central focus, keeping energy prices down. Furthermore, given the likelihood of JGN's proposal being extended in the future to apply to all existing investments, if this is implemented, it will lead to significant increases in distribution tariffs. This is not in the interests of consumers.

**JGN cannot wait to act or there is little downside to acting early** – It is noted the change to asset lives would accelerate the return of capital during the 5-year period by only \$22m. However, at the deep dive workshop on asset lives, the question was posed of JGN whether, if the AER were to accept JGN's approach to shortening asset lives of all asset classes proposed by JGN for new investments, JGN would be likely to apply this approach to existing assets in subsequent regulatory periods. JGN responded that this was highly likely. On the basis that this is correct, there is significant downside to acting early given the value of the capital base that is yet to be depreciated. In circumstances where there is still significant uncertainty, this is a dangerous precedent to be set.

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<sup>4</sup> Australia's Chief Scientist, National Press Club Address, *The orderly transition to the electric planet*, accessed from <https://www.chiefscientist.gov.au/news-and-media/national-press-club-address-orderly-transition-electric-planet>.

## 4. CAPITAL EXPENDITURE

As outlined in the executive summary of this report, the AER DD outlines a number of elements of the capital expenditure included in the Original AA Proposal where further information is required to be provided to enable the AER to reach a definitive position on whether to accept each element. There are also some elements where the AER DD did not accept JGN's proposal but where JGN's Revised AA Proposal provides further information to justify accepting the Revised AA Proposal.

As part of JGN's Revised AA Proposal, JGN has provided further information.

### Actual Capital Expenditure

In our review of the following two items of actual capital expenditure, we would encourage the AER's experts to review the adequacy of the additional information provided by JGN in support of its Revised AA Proposal. But, in both cases, the additional substantiation would appear to be adequate to enable the AER to conclude it is conforming capital expenditure:

- the inclusion of \$28.9M for capitalised overheads incurred during 2015-20 – we note that JGN has provided further information to explain that there has been no double counting of corporate overhead costs.
- the overspend in “other” capital expenditure for property (\$15.8M) incurred during 2015-20 – we note that JGN has submitted a business case and information to explain the tender process undertaken and, in relation to the capex associated with the Melbourne office costs, an independent report on the cost allocation methodology. This is the level of information we would expect should be made available to assess whether the capital expenditure is conforming capital expenditure.

### Forecast Capital Expenditure

In relation to the following items of forecast capital expenditure for 2020-25,

- the AER required further information to justify \$33.9M in forecast information technology (IT) related forecast capital expenditure for 2020-25 – it would appear that JGN has provided further information for each item of IT expenditure which we would expect to be made available to assess whether the capital expenditure is conforming capital expenditure. We would encourage the AER's experts to review the adequacy of the additional information provided by JGN in support of its Revised AA Proposal.
- the AER required further substantiation of 8 programs (totalling \$9.0M) in facilities and pipes related forecast capex. It would also appear that JGN has provided further information for each of the 8 programs which we would expect to be made available to assess whether the capital expenditure is conforming capital expenditure. Again, we would encourage the AER's experts to review the adequacy of the additional information provided by JGN in support of its Revised AA Proposal.
- For the augmentation capex relating to the Aerotropolis project – the AER did not allow most of the forecast capex for this project in the AER DD. The AER sought further clarifications of the demand and project risks at each site within the Aerotropolis development including:
  - o clearly separating committed demand from developers as opposed to inferred demand from third party sources as well as their supply arrangements.
  - o exploration of other planning options that might offer greater investment flexibility other than different main sizes and their associated timing.

- identify any efficiencies and synergies that might have been discussed in the various planning forum and stakeholder meetings JGN participated in which are not typically available in other developments and how JGN has considered and incorporated them into the proposal.

JGN contend that it was wrong for the AER to reject the forecast capex for the proposed Aerotropolis project on the basis that the project was uncertain when the AER itself acknowledged that the investment will be required in the 2020-25 period. We have reviewed the additional information provided by JGN and which has been made publicly available. Based on this information, we do not believe that it is of the level of detail that would enable the regulator to reach a view that it is conforming capital expenditure.

We do not believe that this would create disincentives for JGN to invest in the project. This is because there is a mechanism under the NGR<sup>5</sup> to allow a service provider to obtain the AER's pre-approval of future expenditure for a project before incurring that expenditure, in circumstances where the expenditure is not included in the forecast capital expenditure of an access arrangement and without having to submit a revised access arrangement mid-way through a 5 year plan. Once there is more certainty about the project, JGN could apply to the AER for an advance determination under Rule 80.

- For mains replacement and meter replacement capex – It would also appear that JGN has provided further information about the capex which the AER did not allow in the AER DD and is of a level which we would expect to be made available to assess whether the capital expenditure is conforming capital expenditure. Again, we would encourage the AER's experts to review the adequacy of the additional information provided by JGN in support of its Revised AA Proposal.

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<sup>5</sup> See Rule 80 NGR

## 5. OPERATING EXPENDITURE

We note that JGN's forecast of operating expenditure was updated after JGN submitted its Original AA Proposal (in October 2019, JGN updated its forecast to use 2017/18 operating expenditure levels as the efficient base year (as opposed to the 2018/19 levels) and to change the amount allowed for "movement in provisions").

While TRAC did not have an ability to comment on these changes prior to the AER DD, TRAC believes that these changes are appropriate because they represent a more accurate basis for estimation.

We also note that in relation to the approach to the forecast input price growth rate outlined in the Revised AA Proposal, JGN has not adopted the approach followed by the AER in the AER DD. In that decision, the AER adopts a lower forecast lower input price growth rate compared to that proposed by JGN because the AER has changed its approach to now only use data from Deloitte's real Wage Price Index growth forecasts. The AER justifies this change in approach on the basis that the Deloitte index is more accurate. JGN's approach in the Revised AA Proposal has rejected the approach outlined in the AER DD and continued with its approach in the Original AA Proposal (as revised in Oct 19) – ie using an average of multiple indices. This is because, according to JGN:

- an average is likely to produce more accurate projections;
- the AER is inconsistent in its approach to evaluating CPI and wage price increases; and
- using averages is consistent with what the AER does for electricity networks in relation to output escalation, return on debt and assessing relative opex efficiency.

We would support the use of an average of multiple indices in circumstances where each index does not suffer any inherent flaws. This is particularly important where the building block involves the estimation of a forecast.

## 6. RATE OF RETURN MATTERS

We make three comments in relation to the rate of return (one of which – inflation – is also relevant to other building blocks).

Firstly, while in its Revised AA Proposal, JGN has adopted the AER's methodology as set out in the rate of return guidelines, the values for key elements adopted by the AER in the AER DD differ from the values adopted by JGN in its Original AA Proposal and its Revised AA Proposal because of updated market data and the use by the AER of a different inflation assumption.

JGN's Revised AA Proposal has updated the rate of return parameters for latest data and the AER will do the same again in the Final Decision.

We support this approach.

The second comment we make relates to the approach to estimating the benchmark debt raising costs used in the rate of return calculation. While the AER DD has continued the AER's standard approach to estimating benchmark debt raising costs that it has used in all recent revenue determinations for gas and electricity businesses, the AER:

- notes the review it has undertaken in response to submissions by SAPN on this issue and which contended for a higher indirect debt raising cost allowance based on work done by CEG; and
- concludes that it is not clear at this stage that the information presented by CEG warrants changing its approach to estimating the benchmark allowance because there are problems with the alternative approach proposed by SAPN.

While the AER notes that JGN submitted an updated report from CEG as part of its proposal but did not propose an alternative approach and instead proposed to continue with the AER's approach, the AER is of the view that it needs to supplement its approach with additional information and so, it has requested actual debt raising cost information from service providers.

JGN has identified significant errors in the analysis that the AER has relied on to reject JGN's Original AA Proposal and has retained its approach in that Original AA Proposal.

We believe that any change to the methodology for key aspects of the rate of return – such as debt raising costs – should be considered as part of the rate of return guidelines review and not as part of an individual service provider's access arrangement approvals process. This is because these issues have effect across the whole of industry. The rate of return guidelines process was developed to ensure that industry wide issues should be applied uniformly across industry and that one business should not be advantaged or disadvantaged by timing issues associated with their access arrangement approvals process.

The third comment relates to the approach to inflation. Although JGN has adopted the AER's preferred RBA method for estimating inflation for the 2020- 25 AA period as a placeholder forecast in the AER DD, JGN has:

- proposed 2.38% as the value; and
- recommended that the AER re-consider its approach where its inflation forecasts are significantly above actual inflation to avoid the risk of undercompensating the businesses for their financing costs.

For the same reasons as apply to the benchmark debt raising costs issue raised above, we think that any change in approach should be considered and if warranted, made, as part of a review of the rate of return guidelines.



## 7. OTHER MATTERS

This section will deal with the following matters:

- Smoothing of revenue during the Plan period
- Terms and conditions for the reference service
- CESS
- Volume Boundary metering

### Smoothing of Revenue

JGN has proposed a network price path that seeks to:

- counter forecast movements in other parts of the supply chain, primarily wholesale gas prices, so as to provide customers with the smoothest possible retail bills; and
- still meet the AER DD requirements and preferences, being:
  - o aligning unsmoothed building block costs with smoothed revenue;
  - o minimising tariff variability
  - o providing price signals that reflect the underlying efficient costs; and
  - o minimising the likelihood of variability in tariffs at the start of the subsequent (2025-30) period by aligning final unsmoothed and smoothed revenue to within 3%.

JGN's recommended approach in the Revised AA Proposal involves providing the general steps that the AER could take to give effect to customers' preferences. This involves:

- Targeting price changes that provide relatively steady JGN revenue for 2020-21 to 2022-23 compared to the AER's draft decision price path shape, this will likely result in a lower initial year network price decrease but ongoing network price decreases in 2021-22 and 2022-23.
- The network price decrease in year 2022-23 being slightly higher than the network price decrease in year 2021-22 to reflect the forecast wholesale gas price increase in 2022-23.
- Weight the required price increases in the final two years toward year 5, which has the forecast 1.5% decrease in wholesale prices. This will also help to ensure that year 5 smoothed revenue returns to within 3% of building block revenues.

While we support the principle of seeking to minimise retail tariff variability, we have two concerns.

Firstly, the ideal of seeking to protect customers from the impact of pricing variability caused by movements in other parts of the supply chain (eg the wholesale price) may lead to the unintended consequence of leading to a price shock for customers in the back end of the 5 year regulatory period, particularly where JGN has little or no control over how the prices for these parts of the supply chain are determined.

Wholesale gas prices are an example of this and in recent years, have been subject to significant price volatility. If there were to be a significant increase in the wholesale price of gas towards the middle or end of the 5 year plan period, we are unsure how this impact on retail tariffs could be managed.

We would encourage the AER to test a number of scenarios of wholesale price movements (both in terms of the level of the change and the timing of the change) to see how much the real network price change might need to be altered during the period in order to still remain consistent with the AER DD requirements.



## Terms and Conditions for reference service

While the AER DD approved the minor changes JGN proposed to terms and conditions of the Reference Service Agreement (RSA), the AER has deferred its decision on the more material changes that were proposed. The AER has acknowledged the good work that JGN has done to date to come to an agreement with retailers on the changes but intends to hold a roundtable with JGN and retailers before finalising its assessment.

It would be expected that the ECA would be invited to the roundtable in addition to the retailers.

## CESS

In the AER DD, the AER largely accepted JGN's proposed CESS mechanism. It made the following specific comments:

- The AER is to re-visit the weights to be applied to each of the measures to be used in the contingent payment index
- The targets for each measure should be consistent with the internal targets for each measure
- The AER agrees with Zincara's suggestion that JGN consider and provide further rationale for its proposed range for the contingent payment factor width. In particular, why that range should not be 90–100.

It is noted that the AER has not approved the CESS as a fixed principle because it is not possible to identify whether the CESS will definitively result in consumers being better off. This is because there is no counterfactual outcome to compare a businesses' behaviour with a CESS, relative to its behaviour without a CESS. JGN's Revised AA Proposal no longer seeks to set the CESS as a fixed principle. TRAC supports this change.

JGN's Revised AA Proposal addresses the above matters as follows:

- KPI targets – JGN accepts the removal of outliers; however, JGN has not updated the KPI targets after reviewing internal targets. In addition, to ensure consistency of the logic is maintained when using historical KPIs that now exclude outliers, JGN also propose that outliers are removed from actual performance. TRAC supports this approach.
- Contingent payment factor width – JGN has retained the 80–100 range for the contingent payment factor because it is consistent with the historical volatility of actual performance. TRAC supports this approach.
- Weights for each of the measures in the contingent payment index – TRAC is of the view that there is insufficient information available to suggest one particular set of weights for the measures over another set of weights.

## Volume Boundary Metering

In the AER DD, the AER concludes that based on available information, it is not convinced the benefits of the boundary metering strategy proposed by JGN in its Original AA Proposal outweigh the costs—particularly having regard to the reference service factors.

In the AER DD, the AER indicated that it was however, open to reconsidering its position on JGN's boundary metering strategy in the upcoming final decision but before doing so, it sought further information from JGN and other stakeholders to better ascertain the costs and benefits of JGN's boundary metering strategy, including:

- the likely level of demand for individual hot water metering from JGN in the high-rise buildings market in the 2020–25 period;

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- consumer protections available to customers in embedded networks; and
  - the implication of the potential capex savings from the boundary metering strategy on customer bills.

In the Revised AA Proposal, JGN accepts the AER DD on boundary metering and has retained it as part of the reference service.

TRAC supports this approach and assumes therefore that the AER will no longer undertake a cost/benefit analysis.