

31 October 2018

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Dear Paula

**PROPOSAL FOR THE REMITTAL ITEMS - JEMENA GAS NETWORKS 2015-20
ACCESS ARRANGEMENT FINAL DECISION**

I am pleased to submit this proposal to the Australian Energy Regulator (**AER**) in regards to the aspects of Jemena Gas Networks' (**JGN**) 2015-20 access arrangement final decision from June 2015 (**2015 FD**) that were remitted back to the AER.

Our proposal seeks to expeditiously resolve all outstanding matters the subject of the remittal to deliver an outcome that is in the long term interests of consumers. It reflects our commitments to delivering an affordable, safe and reliable network, investing for customer and economic growth, and delivering better customer service. Our proposal follows a series of consultations in relation to the remittal items and these objectives, held with consumer groups, JGN's Customer Council, the Consumer Challenge Panel (**CCP**) 10, and the AER.

Background

Following the release of the 2015 FD, JGN sought merits review of aspects of the AER decision. The AER subsequently sought judicial review of the decision of the Tribunal.

At the end of these processes, the items remitted back to the AER were:

- market expansion capital expenditure, which was remitted by the Australian Competition Tribunal (**Tribunal**) in February 2016, and
- the cost of debt, which was remitted by the Federal Court in July 2017.

Since that time, JGN has undertaken consultation processes to consider the remittal with a number of stakeholders:

- Market expansion capex—the AER and JGN worked extensively through 2017 to understand different assumptions and models. The AER hosted a round table discussion, including CCP 10, in January 2018.¹
- Cost of debt—the AER initiated a public consultation on the cost of debt² and JGN formally responded to the AER’s position paper.³
- Estimation of revenue over-recovery—the AER and JGN have met several times to work through how best to calculate over-recovery of revenues, and have exchanged several models and scenarios.
- Consideration of drafts of this proposal—JGN initiated the process in July 2018 to outline the content of this proposal to the AER, and briefed CCP 10, followed by providing an overview to customer groups and the JGN Customer Council.

After the Tribunal set aside the 2015 FD, the absence of a final 2015 Access Arrangement decision meant that for the regulatory years 2016/17 (**RY17**), 2017/18 (**RY18**), and 2018/19 (**RY19**), JGN’s prices have been set using Enforceable Undertakings which we submitted to the AER under section 230A of the National Gas Law.

As part of our current customer engagement processes, our customers have been clear that they expect us to deliver a safe, secure and reliable gas supply through the constraint of affordability.

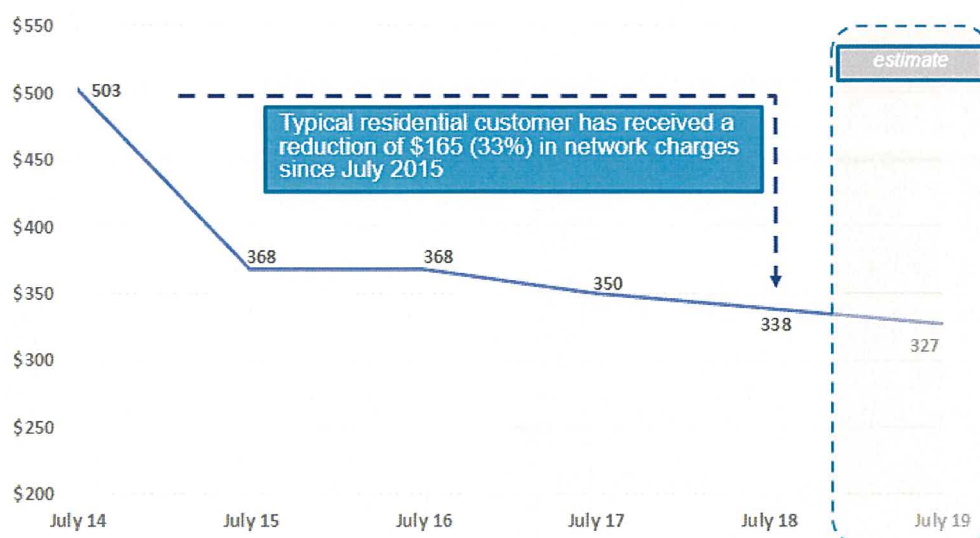
Therefore, we have proactively sought to reduce network charges since 2015 despite the legal uncertainty resulting from these review processes. This has resulted in a \$165 reduction in annual network charges for typical NSW residential gas bill since 2015 (refer Figure 1).

¹ <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/jemena-gas-networks-nsw-access-arrangement-2015-20-remittal/initiation>

² <https://www.aer.gov.au/system/files/Position%20Paper%20-%20remitted%20debt%20decisions%20-%20Australian%20Energy%20Regulator%20-%20Dec%202017.pdf>

³ <https://www.aer.gov.au/system/files/JGN%20-%20Submission%20on%20debt%20position%20paper%20-%2020180223.pdf>

Figure 1. Nominal annual network bill (typical residential customer using 25 GJ per annum)



A consequence of these interim arrangements is that prices effected for RY17 through the Enforceable Undertaking were higher in July 2016 than prices envisaged for that regulatory year under the 2015 FD. This has continued through RY18 and RY19. As a result, and despite some reductions in network charges in 2017 and 2018, we expect to collect \$169M (\$2020) in revenues above what would have occurred had a remade decision been in place during that period.

Relevant to the calculation of over-recovery is the weighted average price cap (**WAPC**) form of control under which JGN is regulated. Under a WAPC, JGN is subject to demand forecasting risk. Where actual demand turns out to be higher or lower than forecast volumes, JGN receives higher or lower revenue than the AER's allowance. This provides JGN with the incentive to outperform the demand forecast accepted by the AER in the 2015 FD. This incentive is aligned to customers' interests as it spreads our fixed costs over more customers in the long run. JGN's demand forecast is reviewed and approved by the AER as part of a regulatory determination. This contrasts to the revenue cap form of control that applies to electricity distribution businesses, where an "unders and overs" account ensures they face no demand forecasting risk. Revenue cap businesses therefore receive no ability to out- or under-perform their revenue allowance, and it is appropriate to always consider actual volumes when retrospectively considering allowances.

Our Proposal

We have sought an overall outcome that is acceptable to all stakeholders. It is best considered as a package rather than being viewed separately as isolated individual items.

We wish to demonstrate our commitment to delivering on our customers' desire for affordable, reliable, and sustainable gas services. To drive towards this, and as part of an expedited resolution to the remittal, JGN's proposal adopts the 2015 FD, including the application of a transition to the trailing average cost of debt for 2015-20 (consistent

with JGN's acceptance of the same methodology as part of the 2018 Rate of Return Guideline review process that the AER is in the process of concluding), with adjustments to account for:

- **An additional allowance of \$21M for market expansion capex:** The additional \$21M (\$2020) for market expansion capex compared with the 2015 FD is consistent with the outcome reached by the AER and CCP 10.
- **An update to the tariff variation mechanism for pass throughs not yet given effect:** The tariff variation mechanism in JGN's 2015-20 AA needs to be updated to provide for the adjustment of RY20 tariffs to include those positive and negative cost pass through items not yet given effect due to the Enforceable Undertakings being in place in each of RY17, RY18 and RY19. To address this, we have included proposed changes to the tariff variation mechanism at **Appendix A**.
- **A reduction of \$169M in revenue for the 2015-20 access arrangement period:** Our proposal provides for a downward revenue adjustment of \$169M (\$2020) to recognise that, for RY17 to RY19, prices were higher than they would have been if the remade final decision had been in place from RY16. This forecast of over-recovery for the entire 2015-2020 period is based on a method that is consistent with JGN's form of control, the WAPC, whereby AER approved volume forecasts are used to set revenues.

We also recognise that the AER has forecast an alternative revenue adjustment of \$178M (2020) which is \$9M (\$2020) higher than JGN's calculation. We have tested these potential outcomes with stakeholders, and consider that the forecast of \$169M (\$2020) is consistent with the WAPC and achieves a result that is within an acceptable range to ensure an expedited resolution to the remittal. Stakeholders also considered that the \$9M (\$2020) benefit retained by JGN is reasonable in the context of the outstanding matters being considered as part of our remittal.

This proposal will continue to deliver lower network charges from 1 July 2019.

Need for cross period revenue smoothing

As these remitted matters are being resolved in year four of our five-year regulatory period, there is only one year remaining in which to make the resulting revenue adjustment. This would lead to undesirable price volatility for our customers (through an X-factor that provides a significant price drop at the end of the current period, but followed by a significant price increase in the subsequent period to return JGN to revenue amounts close to our cost of service). In anticipation, we have proactively sought a rule change to secure a mechanism to allow for smoothing of revenues across 2015-20 and into the 2020-25 Access Arrangement period.

To address this issue, during 2017 and 2018, we proposed and worked closely with the AER, the Australian Energy Market Commission (**AEMC**) and customer advocates to develop a new rule in the National Gas Rules (**NGR**). In August 2018, the AEMC determined to make a new rule, considering that giving effect to cross period revenue smoothing is in customers' interests. The new rule enables the AER to make an

“adjustment determination” to smooth JGN’s revenues across the current and subsequent Access Arrangement periods.⁴ This enables the AER to determine:

- An “adjustment amount” to JGN’s total revenue during the 2015-20 access arrangement period, and
- A “subsequent adjustment amount” to JGN’s total revenue during the 2020-25 access arrangement period that offsets the initial adjustment amount allowing for the time value of money.

We will work collaboratively and expeditiously with the AER to assist the adjustment amount decision-making process. We recognise that the AER needs to make this adjustment determination by 1 March 2019, before the rule expires. An outcome where the rule expires and prices are not smoothed is not in customers’ interests.

What this Proposal means for our customers

- **Simple, certain and timely:** AER acceptance of this Proposal will finally resolve the remittal matters in full, thereby providing certainty to customers regarding their current and future prices. It provides a simple and expedited process that enhances certainty, and minimises administrative cost due to there being no further need for Enforceable Undertakings or true ups.
- **Customer benefit from resolution of remittal items:** JGN’s acceptance of the AER’s:
 - approach to the cost of debt avoids a potential maximum \$107M increase in network costs
 - proposal for additional market expansion capex avoids up to \$93M of capex allowance, which would otherwise have been added to the regulatory asset base and earn a return on this investment and recover the return of capital (depreciation) .
- **Framework for revenues to be returned to customers:** The Proposal enables the AER to consider the appropriate mechanisms to reduce JGN’s future revenues by \$169M and return this amount to customers.
- **Pricing stability:** Customers avoid year on year price volatility and maintain annual tariff variation certainty via:
 - having the cross period smoothing rule change now in place, which allows for the AER to approve steady price decreases for RY20 and for those to continue into the next period

⁴ <https://www.aemc.gov.au/rule-changes/cross-period-revenue-smoothing-gas>

- the processing of JGN's positive and negative cost pass throughs (not given effect through Enforceable Undertakings over RY17 to RY19) in a way that maintains AER oversight of these changes.

We have consulted with consumer groups, JGN's Customer Council, and the CCP 10 on the detail of this Proposal. Letters of support from stakeholders will be directly communicated to the AER.

Please contact me if you have any questions or wish to discuss our proposal further. Alternatively, your staff may wish to contact our General Manager Regulation, Usman Saadat on 02 9867 7483.

Yours sincerely



Shaun Reardon
Executive General Manager, Customer & Markets
Jemena Limited

Appendix A Proposed tariff variation mechanism amendments to JGN's June 2015 Access Arrangement

Amendments proposed are to *Access Arrangement JGN's NSW gas distribution networks 1 July 2015 – 30 June 2020 (June 2015)*

[1] Section 3. Reference Tariff Variation Mechanism

In Clause 3.6(a), omit "March" and substitute "April".

[2] Schedule 3 Reference Tariff Adjustment Factors

Omit the current Schedule 3 and substitute with the following:

Schedule 3 Reference Tariff adjustment factors

Automatic adjustment factor (A)

$$A_t = \frac{(1 + A'_t)}{(1 + A'_{t-1})} - 1$$

where:

A'_{t-1} is:

- (a) zero when $t-1$ refers to Financial Year 2015-16, Financial Year 2016-17, Financial Year 2017-18, Financial Year 2018-19; or
- (b) the value of A'_t determined in the Financial Year $t-1$ for all other years;

and

$$A'_t = \frac{(L_{t-2} + U_{t-2} + C_{t-2} + T_{t-2})[(1 + \text{realWACC}_{t-1})(1 + \text{realWACC}_t)(1 + \text{CPI}_{t-1})]}{(1 - X_t) \sum_{x=1}^n \sum_{y=1}^m p_{t-1}^{xy} q_{t-2}^{xy}}$$

where:

L_{t-2} is the licence fee factor amount, as defined in this Schedule 3, for Financial Year $t-2$.

When $t-2$ is Financial Year 2017-18, L_{t-2} is the sum of:

$$L_{2014} * (1 + \text{realWACC}_{2015}) * (1 + \text{CPI}_{2015}) * (1 + \text{realWACC}_{2016}) * (1 + \text{CPI}_{2016}) * (1 + \text{realWACC}_{2017}) * (1 + \text{CPI}_{2017}) * (1 + \text{realWACC}_{2018}) * (1 + \text{CPI}_{2018}); \text{ and}$$

$$L_{2015}*(1+realWACC_{2016})*(1+CPI_{2016})$$

$$*(1+realWACC_{2017})*(1+CPI_{2017}) *(1+real$$

$$WACC_{2018})*(1+CPI_{2018}); \text{ and}$$

$$L_{2016}*(1+realWACC_{2017})*(1+CPI_{2017})*(1+realWACC_{2018})*(1+CP$$

$$I_{2018}); \text{ and}$$

$$L_{2017}*(1+realWACC_{2018})*(1+CPI_{2018}); \text{ and}$$

$$L_{2018}$$

where:

L_{2014} is the licence fee factor amount, as defined in this Schedule 3, for Financial Year 2013-14;

L_{2015} is the licence fee factor amount, as defined in this Schedule 3, for Financial Year 2014-15;

L_{2016} is the licence fee factor amount, as defined in this Schedule 3, for Financial Year 2015-16;

L_{2017} is the licence fee factor amount, as defined in this Schedule 3, for Financial Year 2016-17;

L_{2018} is the licence fee factor amount, as defined in this Schedule 3, for Financial Year 2017-18;

$realWACC_{2015}$ means the real vanilla weighted average cost of capital of 7.63 per cent;

$realWACC_{2016}$ means the real vanilla weighted average cost of capital of 2.78% per cent;

$realWACC_{2017}$ means the real vanilla weighted average cost of capital of 2.85% per cent

$realWACC_{2018}$ means the real vanilla weighted average cost of capital of 2.90% per cent

CPI_{2015} means the consumer price index of 1.72 per cent;

CPI_{2016} means the consumer price index of 1.69 per cent;

CPI_{2017} means the consumer price index of 1.48 per cent;

CPI_{2018} means the consumer price index of 1.91 per cent;

U_{t-2} is the UAG factor amount, as defined in this Schedule 3, for Financial Year $t-2$;

When $t-2$ is Financial Year 2017-18, U_{t-2} is the sum of:

$$U_{2015}*(1+realWACC_{2016})*(1+CPI_{2016})$$

$$*(1+realWACC_{2017})*(1+CPI_{2017}) *(1+real$$

$$WACC_{2018})*(1+CPI_{2018}); \text{ and}$$

$U_{2016}*(1+realWACC_{2017})*(1+CPI_{2017})*(1+realWACC_{2018})*(1+CPI_{2018})$; and

$U_{2017}*(1+realWACC_{2018})*(1+CPI_{2018})$; and

U_{2018}

where:

U_{2015} is the UAG factor amount, as defined in this Schedule 3, for Financial Year 2014-15;

U_{2016} is the UAG factor amount, as defined in this Schedule 3, for Financial Year 2015-16;

U_{2017} is the UAG factor amount, as defined in this Schedule 3, for Financial Year 2016-17;

U_{2018} is the UAG factor amount, as defined in this Schedule 3, for Financial Year 2017-18;

C_{t-2} is the Carbon Cost factor amount, as defined in this Schedule 3, for Financial Year $t-2$.

When $t-2$ is the Financial Year 2014-15 $C_{2015}=0$;

When $t-2$ is Financial Year 2017-18, C_{t-2} is the sum of:

$C_{2016}*(1+realWACC_{2017})*(1+CPI_{2017})*(1+realWACC_{2018})*(1+CPI_{2018})$; and

$C_{2017}*(1+realWACC_{2018})*(1+CPI_{2018})$; and

C_{2018}

where:

C_{2016} is the Carbon Cost factor amount, as defined in this Schedule 3, for Financial Year 2015-16;

C_{2017} is the Carbon Cost factor amount, as defined in this Schedule 3, for Financial Year 2016-17;

C_{2018} is the Carbon Cost factor amount, as defined in this Schedule 3, for Financial Year 2017-18;

T_{t-2} is the Relevant Tax factor amount for Financial Year $t-2$;

When $t-2$ is Financial Year 2017-18, T_{t-2} is the sum of:

$T_{2015}*(1+realWACC_{2016})*(1+CPI_{2016})$
 $*(1+realWACC_{2017})*(1+CPI_{2017})$
 $*(1+realWACC_{2018})*(1+CPI_{2018})$; and

$T_{2016}*(1+realWACC_{2017})*(1+CPI_{2017})*(1+realWACC_{2018})*(1+CPI_{2018})$; and

$T_{2017}*(1+realWACC_{2018})*(1+CPI_{2018})$; and

T_{2018}

where:

T_{2015} is the Relevant Tax factor amount, as defined in this Schedule 3, for Financial Year 2014-15;

T_{2016} is the Relevant Tax factor amount, as defined in this Schedule 3, for Financial Year 2015-16;

T_{2017} is the Relevant Tax factor amount, as defined in this Schedule 3, for Financial Year 2016-17;

T_{2018} is the Relevant Tax factor amount, as defined in this Schedule 3, for Financial Year 2017-18;

$realWACC_t$ is the real vanilla weighted average cost of capital as per that set out in the AER's Final Decision and updated annually within JGN's revenue model;

CPI_t has the same meaning as set out in clause 3.2;

CPI_{t-1} is the value of CPI_t determined in the Financial Year $t-1$;

X_t has the same meaning as set out in clause 3.2;

p_{t-1}^{xy} has the same meaning as set out in clause 3.2; and

q_{t-2}^{xy} has the same meaning as set out in clause 3.2.

Factor amounts

1.1 Licence fee factor amount

The licence fee factor amount for a Financial Year is to be calculated as follows:

- (a) the actual cost incurred by the Service Provider as a result of any AER, IPART, AEMO, EWON or any other relevant regulator, authority or State or Commonwealth Government's authorisation fees, licence fees or statutory charges imposed on the Service Provider which is related to the ownership or operation of the Network in the Financial Year,

minus

- (b) the forecast of the cost incurred by the Service Provider as a result of any AER, IPART, AEMO, EWON or any other relevant regulator, authority or State or Commonwealth Government's authorisation fees, licence fees or statutory charges imposed on the Service Provider which is related to the ownership or operation of the Network included in the AER's relevant final decision for that Financial Year.

1.2 UAG factor amount

When $t-2$ is Financial Year 2014-15, the UAG factor amount for $t-2$ is to be calculated as follows:

- (a) the benchmark cost incurred by the Service Provider for purchases of gas as UAG, calculated as the product of:

- (i) gas receipts in gigajoules for Financial Year 2014-15;
- (ii) the UAG Cost for Financial Year 2014-15 in \$/gigajoule;
- (iii) the UAG target rate of 2.34 per cent of gas receipts,

minus

- (b) \$13.1M (\$2010), being the forecast of the total UAG costs included in the AER's final decision for Financial Year 2014-15 as set out in Schedule 8 of the 2010-15 Access Arrangement.

For all other Financial Years in the Access Arrangement Period, the UAG factor amount for the Financial Year is to be calculated as follows:

- (c) the benchmark cost incurred by the Service Provider for purchases of gas as UAG, calculated as the sum of:

the product of:

- (i) aggregate gas withdrawals at all daily metered Delivery Points in gigajoules during the Financial Year;
- (ii) the UAG Cost for the Financial Year in \$/gigajoule; and
- (iii) the UAG component target rate of 0.427 per cent of daily metered withdrawals,

and the product of:

- (iv) aggregate volume market residual receipts in gigajoules for the Financial Year, calculated as aggregate Gas receipts for the Financial Year less aggregate gas withdrawals at all daily metered Delivery Points during the Financial Year;
- (v) the UAG Cost for the Financial Year in \$/gigajoule; and
- (vi) the UAG component target rate of 5.16 per cent of volume market residual receipts:

minus

- (d) the forecast allowance of the total UAG costs included in the AER's relevant final decision for the Financial Year.

Reference Tariffs will be adjusted in the event that total UAG costs cease to be a Network cost during the Access Arrangement Period.

1.3 Carbon Cost factor amount

The Carbon Cost factor amount for a Financial Year is to be calculated as follows:

- (a) the actual cost incurred by the Service Provider, as approved by the AER, as a result of the operation of a Carbon Scheme, in the Financial Year,

minus

- (b) the forecast of the cost incurred by the Service Provider, as approved by the AER, as a result of the operation of a Carbon Scheme and included in the AER's relevant final decision, in that Financial Year.

1.4 Relevant Tax factor amount

The Relevant Tax factor amount for a Financial Year is to be calculated as follows:

- (a) the actual cost incurred by the Service Provider in paying any Relevant Tax, in the Financial Year,

minus

- (b) the forecast of the cost incurred by the Service Provider in paying any Relevant Tax included in the AER's relevant final decision, in that Financial Year.

1.5 Cost Pass Through factor

$$PT_t = \frac{(1 + PT'_t)}{(1 + PT'_{t-1})} - 1$$

where:

PT'_{t-1} is:

- (c) zero when t-1 refers to Financial Year 2014-15, Financial Year 2015-16, Financial Year 2016-17, Financial Year 2017-18, Financial Year 2018-19;
- (d) the value of PT'_t determined in the Financial Year t-1 for all other Financial Years in the Access Arrangement Period,

and

$$PT'_t = \frac{AP_t}{(1 + CPI_t)(1 - X_t)(1 + A_t) \sum_{x=1}^n \sum_{y=1}^m p_{t-1}^{xy} q_{t-2}^{xy}}$$

where,

AP_t is:

- (a) any Determined Pass Through Amount that the Service Provider proposes to pass through in whole or in part in Financial Year t, and / or
- (b) any pass through amounts arising from cost pass through events (as that term is defined in the access arrangement applying to this Network

in the immediately prior access arrangement period) occurring in the immediately prior access arrangement period that the Service Provider proposes to pass through in whole or in part in Financial Year t ,

that includes an amount to reflect the time value of money between incurring the costs and recovering the costs, and excludes any amounts already passed through in Reference Tariffs;

| | |
|----------------|--|
| CPI_t | has the same meaning as set out in clause 3.2; |
| X_t | has the same meaning as set out in clause 3.2; |
| A_t | is the automatic adjustment factor for Financial Year t as defined in this Schedule 3; |
| p_{t-1}^{xy} | has the same meaning as set out in clause 3.2; |
| q_{t-2}^{xy} | has the same meaning as set out in clause 3.2. |

[END OF PROPOSED AMENDMENT]
