10 August 2020

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Evoenergy – Proposed Access arrangement 2021-26 – 1 July 2020

EnergyAustralia is one of Australia's largest energy companies with around 2.5 million electricity and gas accounts across eastern Australia. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation capacity.

We appreciate the opportunity to provide comments on Evoenergy's initial access arrangement proposal.

Our high-level reflections on the proposed access arrangement are similar to those on recent proposals for the Victorian electricity networks[1]:

- The headline price reductions being promoted to customers are due to separate AER determinations on the rate of return and benchmark tax liabilities rather than network expenditures, which are largely flat or slightly increasing. There may be scope to challenge Evoenergy on elements of the proposal that are within its control to deliver further pricing benefits for customers.

- Customer preferences expressed in consultation leading into the development of the proposed access arrangement may need to be revisited in light of cost of living pressures arising from COVID-19 impacts.

- Similarly, pressures being felt by businesses across the broader economy to achieve cost reductions in expectation of sustained economic downturn, and expectations of low or negative investment returns, may also need to be considered for regulated businesses. Forecasts underlying the proposal, primarily energy demand/ consumption and cost inputs, will need to be updated as economic and health impacts become clearer.

We also have further specific observations on operating expenditure (opex), capital expenditure (capex), Evoenergy's Reference Service Agreement (RSA), and asset stranding risk.

[1] https://www.aer.gov.au/system/files/EnergyAustralia%20-%20Submission%20on%20the%20Victorian%20Electricity%20Distribution%20Regulatory%20Proposal%202021-26%20-%20June%202020_3.pdf

Operating expenditure

Evoenergy's base year (and generally the opex estimates for 2019-20 and 2020-21) reflects an increase of around 10 per cent compared to recent actual expenditures.

With respect to pigging costs, we note Evoenergy's accounting justifications for recategorising these as opex[2] but question the extent to which this reflects incentives arising from stranding risk (see below). Similarly, opex amounts for marketing within base year expenditures, to the extent they cater for customer preferences to use more gas and in maintaining Evoenergy's revenue base, are worth considering as part of a broader review around dealing with stranding risk.

Evoenergy's proposed productivity adjustment of 0.5 per cent per year compares to 0.74 per cent proposed by and accepted for JGN. Economic Insights' measure of multilateral total factor productivity indicates that Evoenergy's productivity level is comparable to JGN's.[3] Economic Insights' measure of the average rate of technical change is between 0.54 and 1.35 per cent. It considers the resulting point estimate of 0.95, which appears to reflect an update to the 0.74 value calculated recently for JGN, is more likely to reflect an upper bound given measurement issues and a somewhat lower value should be used.[4] Evoenergy's proposed value of 0.5 per cent is below the range estimated by Economic Insights. Further scrutiny should be applied to the weight Evoenergy places on analysis by Economic Insights, as well as the relevance of productivity estimates for electricity businesses, earlier modelling of gas businesses, and its expectation of a doubling of insurance premiums by 2025-26.[5]

Capital expenditure

A material reduction in proposed capex with respect to spending in the current access arrangement period would be expected given the ACT Government's longer-term policy stance. Evoenergy is still obliged to accommodate new connections requests and government policy appears to allow supply to new estates where this is valued by customers. However we now question the prudence of any capex where this is on long-lived assets, and spending on other assets to facilitate connections and throughput should also be questioned given incentives on gas businesses to expand their revenue base in the face of stranding risk.

In terms of 'stay in business - network renewal' capex, Evoenergy has identified safety and risk in its justifications as well as potential regulatory compliance issues.[6] We expect the AER to give further consideration to how proposed expenditures affect measurable changes in risk and network performance in Evoenergy's detailed business cases and, where relevant, how this translates into maintaining or improving customer outcomes. Information contained in Evoenergy's summary documents suggests it is maintaining high levels of network performance (e.g. a SAIDI of zero in 2018-19[7]) and so network reliability may not be a significant cost driver.

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[2] Evoenergy, *Attachment 2 – operating expenditure – Access Arrangement Information*, June 2020, p. 2-11.
[3] Evoenergy, *Appendix 2.2 - Relative efficiency and forecast productivity growth for Evoenergy - Economic Insights - Access arrangement information*, June 2020, pp. 7-8.
[4] ibid.
[5] Evoenergy, *Attachment 2 – operating expenditure – Access Arrangement Information*, June 2020, p. 2-10 and 2-11.
[6] Evoenergy, *Attachment 3 – capital expenditure – Access Arrangement Information*, June 2020, p. 3-13.
[7] Evoenergy, *Overview – Access Arrangement Information, June 2020*, p. 4.

Proposed spending on meter replacement may also warrant further attention. Evoenergy states it has been able to constrain spending in the current access arrangement period due to better than expected asset performance and proactive monitoring, however suggests this has created a backlog of deferred replacements for residential meters.[8] There may be an increase in the scope of works however we might also expect some reduction in the underlying trend and into the next access arrangement period in line with improved knowledge of asset performance.

Reference service agreement

Our comments on Evoenergy's RSA reflect our prior and unresolved concerns on JGN's RSA, which it in part proposes to adopt:

- a rebalancing of the liability and indemnity regime
- new requirements for insurance for users and for Evoenergy
- updating of the clauses for disconnection processes and arrangements.

Our detailed comments on individual clauses are below.

Clause	Description	EnergyAustralia comments
10.1(b)	*Where Evoenergy reasonably believes that the conveyance of Gas which does not meet the Specification is necessary to ensure the safety of the public or the security of the Network and the Gas is conveyed in accordance with regulation 24(2)(a) of the Gas Supply (Safety and Network Management) Regulation 2013 (NSW), then Evoenergy will be deemed to have delivered Gas that meets the Specification to the extent the Gas is delivered in accordance with regulation 24(2).*	Although this clause was in the proceeding RSA, EnergyAustralia do not believe this indemnity should be as encompassing and poorly defined as *'safety of the public'* and *'security of the network'*. EnergyAustralia suggest Evoenergy to include *'safety of the public'* and *'security of the network'* in *'Definitions and Interpretation'*, to clearly outline what threshold of incident would be included under these terms.
26.3	*Indemnity in favour of Evoenergy* *The User must indemnify and hold harmless Evoenergy and its Associates (each an Evoenergy Indemnified Party) from and against any Loss suffered or incurred by any of them in connection with, or arising as a result of, any:* *(b) delivery of Gas on behalf of the User at any Receipt Point which does not meet the Specification or pressure requirements for Gas delivered at the Receipt Point under this Agreement;*	EnergyAustralia does not support the inclusion of broad indemnities into the RSA, as we do not believe this does not incentivise networks to take the necessary precautions to ensure these liability events do not occur. We do not believe it is reasonable to allow indemnity on Evoenergy from achieving *'specification or pressure requirements';* specifically, pressure requirements as this solely the remit of Evoenergy.

[8] Evoenergy, *Attachment 3 – capital expenditure – Access Arrangement Information*, June 2020. pp. 3-15 and 3-16.

Stranding risk from climate policy

We refer to our earlier submission on the same issue arising in JGN's proposed access arrangement. [9] The potential stranding of gas infrastructure assets is an issue that regulators and governments should be considering sector-wide and should not be examined in isolation for each gas access arrangement. We note the ACT Government has indicated that it is live to issues of financial impacts for customers in transitioning away from natural gas.[10] We would support the AER initiating a broader policy review in terms of whether the regulatory framework can and should accommodate government policies to either move away from gas and associated transport infrastructure entirely or towards shipping zero carbon gas.

From a customer perspective, we are keen to maintain visibility of price paths over the longer term which are ideally stable and overall reflect competitive market outcomes. There is a risk that the deferral of this issue into later access arrangement periods may result in sharp price increases or other impacts that can be mitigated now, rather than having to wait for discrete events in terms of policy announcements.

We consider there is a threshold question in terms of whether businesses involved in carbon intensive industries should be protected from asset stranding risk associated with climate policy. Entities operating in competitive markets frequently face the prospect of losing significant business value in the face of changing circumstances unless they take steps to adapt. While the regime embodied in the NGR broadly attempts to emulate competitive market outcomes in terms of price and quality of service, it does not allow for the write-down of asset values that occasionally occur because of government or regulatory interventions. The regime may also not be flexible enough to accommodate fundamental shifts in service delivery e.g. innovative investments and activities relating to upstream gas supply sources that are high risk, or not within the definition of reference services.

The question of whether the regime currently does protect network businesses from stranding risk is also critical. Statements made recently by the AER suggest this may be the case:[11]

> …we consider that there is effectively no stranding risk from underutilised assets in the current regulatory regime. Although an asset may become unused (or underutilised) on one part of the network, other consumers in other areas will continue to cover the residual costs of these assets. We are also required by the NGR to allow the business to recover the full costs of its assets, and apply a net present value (NPV) neutral approach so the business is compensated for its investment.

The AER may be correct however we question the implication of the NPV neutral approach. Scenario modelling should be undertaken to explore values of assets, revenues, prices and customer consumption patterns over a time horizon of 25 to 30 years where gas infrastructure may become redundant. We see AGN conducted some

[9] https://www.aer.gov.au/system/files/EnergyAustralia%20-%20Submission%20on%20JGN%202020-25%20AA%20Proposal%20-%20Cover%20letter%20-%20August%202019.pdf

[10] https://www.evoenergy.com.au/-/media/evoenergy/documents/gas/minister-rattenbury-letter-to-citizens-jury.pdf

[11] AER, *Final Decision Jemena Gas Networks (NSW) Ltd - Access Arrangement 2020 to 2025 - Attachment 4 Regulatory depreciation*, June 2020, p. 12.

longer-term modelling for the purposes of consulting on its draft plan[12] and this should be built upon.

A quick rule of thumb calculation using Evoenergy's proposal post-tax revenue model suggests that, assuming no new capex or customer growth from today's levels, and depreciation at its proposed rates, customers would need to pay a residual asset value of $97 million, or $636 per customer on average (in real, 2021 terms) by 2045. This compares to the $389 each customer would pay in 2021-22, on average, in terms of annual total revenues. A similar calculation for AGN suggests that this notional residual asset payment would be 4.5 times more than annual per customer revenues. A more sophisticated modelling analysis would explore the need for renewal capex and maintenance expenditures to sustain service quality and network condition, ultimately resulting in more revenues to be recovered as network expiry approaches. Customer numbers and average consumption would likely significantly decline in these types of forward scenarios as fuel switching takes place. Alternative scenarios involving hydrogen or biogas reticulation could also be constructed to investigate customer impacts.

The absence of clarity on when or how (or whether) the recovery of long-term investment value takes place over the next 5 or 6 access arrangement periods has the potential to result in perverse outcomes, as businesses respond to risk in different ways. There are elements of the proposals currently before the AER that reflect this and warrant the attention of policy makers. Other challenges are yet to be treated by the AER under the NGR and we expect will be directly engaged with in the current access arrangements proposals, including in light of detailed consideration by the CCP.[13] For example:

- Businesses may seek a pragmatic solution by proposing only to use shorter remaining lives for assets to be commissioned in the forecast period, but maintain longer lives for those already commissioned. However, such differential treatment may not satisfy the NGR requirements as they are the same 'asset' or group of asset. A further consideration is that some proposed asset lives will still extend beyond 2045, leaving prospects for further adjustments and associated price impacts in future access arrangement reviews.

- Proposals for differential pricing for customers connecting with new assets (with much shorter lives), versus existing customers, give rise to equity considerations and may also distort price signals for efficient asset utilisation over time.

- In spite of the AER's statements regarding the NPV neutral approach, there may still be a general perception of risk that prudent investments to maintain existing assets will not be recovered, which may deter such investment in the first place.

- Businesses may continue to propose spending on market expansion and encourage consumption through tariff design in order to broaden their revenue base, such that returns of assets can be recovered while minimising price impacts for individual customers. They may also be legally obliged to connect new customers and we note the ACT Government appears to be still allowing gas

[12] https://www.aer.gov.au/system/files/CCP24%20-%20Advice%20to%20AER%20-%20AGN%20Draft%20Plan%20response%20-%20June%202020.pdf. See page 40.

[13] https://www.aer.gov.au/system/files/CCP24%20-%20Advice%20to%20AER%20-%20AGN%20Draft%20Plan%20response%20-%20June%202020.pdf

reticulation in new suburbs where customers value this. However, any investment in new long lived assets ultimately adds to the problem of eventual cost recovery.

- Counter to this, we expect further government action to encourage energy efficiency and fuel switching, which directly erodes regulated revenue bases and pushes up prices, with both effects reinforcing one another.

- Proposed spending on risk mitigation measures, primarily upstream hydrogen investment and mains replacement to accommodate hydrogen, may not be prudent where the AER determines that assets can be fully recovered and no stranding risk exists.

- There may be a need to treat networks differently because of locational issues e.g. prospects of hydrogen or biogas reticulation will depend on supply sources. Similarly, prospects for shipping new gas sources via transmission pipelines for export and for industrial use will be different for domestic use via distribution networks.

If you would like to discuss this submission, please contact me on [redacted] or [redacted].

Regards

[redacted]

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Acting Industry Regulation Leader