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LIGHT THE WAY

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Australian Gas Networks South Australia (AGN) – 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 AGN'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 distribution networks¹:

- The headline and initial price reductions being promoted to customers are largely due to separate AER determinations on the rate of return and benchmark tax liabilities rather than network expenditures. There may be scope to challenge AGN 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 proposed operating expenditure (opex) 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

The proposed 17 per cent increase in expenditure on unaccounted for gas (UAFG) is difficult to scrutinise as key data in AGN's supporting document² are redacted, even though most of these data are sourced from the ACCC's February Gas Inquiry report. Similarly, AGN's volume forecasts have been treated as confidential. We note that AGN proposes to update its proposal in line with actual prices of procuring gas from suppliers. The AER may wish to examine whether AGN (and other regulated gas networks) face appropriate incentives to minimise costs associated with UAFG rather than pass these through to customers, which might include an examination of actual UAFG settlements for the most recent three years on which volume forecasts have been based.³

AGN notes that 84 per cent of customers supported using renewable or carbon neutral gas from a bioenergy project in its UAFG, which could cost up to \$5.50 on the average annual bill.⁴ While we support moves towards a fully decarbonised energy supply, customer preferences to explicitly pay certain amounts for items such as these may need to be reconsidered in the wake of COVID-19 economic impacts as noted above.

AGN also proposes step changes associated with the Vulnerable Customer Assistance Program (VCAP) and for digital communications. We support measures for assisting vulnerable customers as well as improved customer communications. Improved communications with vulnerable customers is particularly important as engagement with these customers can be difficult. Upgrades in relation to digital communication channels would provide a better customer experience.

We understand retailer representatives were engaged in discussing some of the potential activities the VCAP, and AGN should be applauded for its approach to engagement overall. While AGN has developed cost estimates with respect to discrete activities in a fine level of detail, including estimated customer rebates⁵, the activities do not yet appear to be fully determined and will be refined with stakeholders over the access period.⁶ Furthermore, our expectation is that customers may now support further or different activities than canvassed previously in light of vulnerability issues in the wake of the COVID-19 outbreak.

AGN's proposed productivity factor should be compared to those proposed or recently determined for other network businesses, taking into account relative efficiencies and uncontrollable factors, and movements in the notional efficiency frontier. Data produced by Economic Insights for AGN suggests it appears to be achieving average levels of efficiency.⁷ AGN notes it has decided to apply a productivity factor of 0.4 per cent, which is above the 0.25 per cent based on ACIL Allen's recommendations⁸ but below that for Jemena Gas Networks NSW (0.74 per cent) and 0.5 per cent proposed by Evoenergy.

Other factors affecting opex trend adjustments, including output growth and input cost escalation, are also likely to require consideration in light of COVID-19 impacts.

² AGN, *Attachment 7.9 - Core Energy, Independent Assessment of the market price of gas*, July 2020.

³ AGN, *Five year plan for our South Australian network July 2021 – June 2026 - Final Plan*, July 2020, p. 82.

⁴ *ibid.*, p. 52.

⁵ AGN, *Attachment 7.2 - Opex business cases*, July 2020.

⁶ AGN, *Final Plan*, p. 74.

⁷ *ibid.*, p. 77.

⁸ *ibid.*, p. 80.

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 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 is may be the case:¹⁰

...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 longer-term modelling for the purposes of consulting on its draft plan¹¹ and this should be built upon.

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

¹¹ <https://www.aer.gov.au/system/files/CCP24%20-%20Advice%20to%20AER%20-%20AGN%20Draft%20Plan%20response%20-%20June%202020.pdf>. See page 40.

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.¹² 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, marketing 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. However, any investment in new long lived assets ultimately adds to the problem of eventual cost recovery.

¹² <https://www.aer.gov.au/system/files/CCP24%20-%20Advice%20to%20AER%20-%20AGN%20Draft%20Plan%20response%20-%20June%202020.pdf>

- 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