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Dear Mr Gulbenkoglu

Gas Access Arrangement proposals 2023-28 for AusNet, Multinet and AGIG — 1 July 2022

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts across eastern Australia. We also own, operate and contract a diversified 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.

EnergyAustralia appreciates the opportunity to participate in the AER's review of the Victorian gas distribution networks 2023-2028 Access Arrangement. The AER is considering the access arrangement proposals for AGN, Multinet and AusNet at a time when customers are facing considerable cost of living pressures, both from within and outside of energy supply chains. In addition, emissions reductions targets out to 2050 will likely mean that significant amounts of gas infrastructure will be stranded. This stranding risk is slowly being realised through interim policy announcements like those underpinning the Victorian government's gas substitution roadmap. The AER must consider these factors in addition to its 'business as usual' task of encouraging regulated network businesses to achieve investment and operational efficiencies, and so delivering long term value for customers.

Spending on hydrogen readiness/ stranding risk issues

EnergyAustralia is supportive of hydrogen and renewable gas as an alternative to carbon intensive 'natural gas', particularly in industries that are unable to economically decarbonise via electrification. Heavy industries and manufacturers, as well as gas power generators (EnergyAustralia's Tallawarra gas power station will be capable of using hydrogen as a fuel source[1]), will require hydrogen and renewable gas and it is vital the gas industry, regulators, and the government, work to ensure this transition is done in an efficient and equitable fashion. However, we do not believe that there is any need, desire, or latent industry, that requires distribution networks to supply hydrogen to residential customers via the distribution network.

The Vic gas distribution networks have adjusted their future fuel expenditure but have kept some under the guise of 'no regrets'; AGN & MGN have retained hydrogen readiness and renewable gas communication/education in their amended proposal. We believe that any cost increase to customers, for hydrogen readiness or education, in the coming regulatory period will be regretful, as the energy transition is

[1] Tallawarra to be hydrogen-capable - ABC News

forecast to have pronounced impacts on customer's bills[2][3], coupled with the cost of living concerns already being faced. It becomes more regretful when we consider that this expense is contributed without any certainty that distribution connected residential customers will have any use for hydrogen or receive any benefit from the distribution network transporting the fuel to industries that can incorporate it.

It is forecast that hydrogen will not be economically viable as a replacement for natural gas until 2030[4], at the earliest. It is unlikely that retailers will choose to purchase and sell hydrogen to distribution connected residential customers before this nexus of parity occurs, and as such, customers will not receive hydrogen as a product or have a use for it until it becomes a common addition in the distribution system. When this occurs, not until 2030 at the earliest, customers will then encounter an additional complexity if the inclusion of hydrogen exceeds the 'natural gas equivalent' levels (currently viewed as a maximum allowable of 10%[5]) before they will need to invest in replacement appliances or make alterations to existing appliances.

EnergyAustralia believes that the AER should remove any expenditure for hydrogen readiness and communication/education. This investment should not be allowed until there is more certainty that hydrogen will be an economical and environmentally suitable alternative for natural gas. This will become clearer towards the end of the next regulatory period, 2028. This 'no regrets' approach will ensure that customers are not unnecessarily investing before there is a defined need. The Vic gas distribution networks can continue to investigate hydrogen inclusion, develop ring-fenced hydrogen production facilities, and work with heavy industry on how to provide hydrogen as a natural gas alternative, but these decisions should not be recoverable from distribution connected residential customers, as these business decisions will likely lead to a new business model for the distribution businesses, one in which the historical reasoning for residential customer investment in the network no longer applies.

A key point of contention in early stakeholder discussions with the Vic gas distribution networks regarding their proposals related to their approach towards stranding risk, with the consensus amongst the networks that stranding risk was most appropriately addressed through accelerated depreciation. The contention of stakeholders focused on the contradiction between accelerating depreciation due to the stranding risk/ death spiral of a network that was no longer used and the proposed capex investment by the networks for mains replacement and hydrogen readiness.

MGN's proposed capex reflects a significant increase from $468 million in the current period to a proposed $669 million, which is almost entirely due to mains replacement spending. Such a significant increase in MGN's total capital spending is at odds with concerns around asset stranding, noting this additional investment will significantly increase average remaining asset lives and the amount repayable under the RAB.

The Vic gas distributors adjusted proposals, following the release of the Vic government's Gas Substitution Roadmap (GSR), with reductions in capex aligned with a forecast reduction in customer growth; however, this was primarily focused on customer connections, and there was very little capex/opex reduction to account for the existing customers that are expected to reduce their gas consumption or disconnect entirely in the coming access arrangement period. The GSR outlined restrictions on mandatory gas connections for new developments, but also forecast a significant reduction in the gas consumption/demand of existing customers; partially led by government subsidies provided for replacing gas appliances with electrical. We are concerned that the proposals do not adequately consider the reduced demand outlined in the GSR, and this increases the stranding risk of recovering sunk costs. EnergyAustralia suggests the AER consider whether further reductions in the proposed capex/opex are required to accommodate for the forecast reductions outlined in the GSR.

[2] What does Australia's energy transition look like - AFR
[3] Higher prices a cost of energy transition - AFR
[4] Green hydrogen will be cost-competitive with grey H2 by 2030 - Recharge News
[5] Hydrogen in the gas distribution network - Department of Energy and Mining South Australia

Other areas where proposed spending should be challenged

In addition to spending on renewable gas initiatives, there appears to be scope to challenge the networks on the prudence and efficiency of their other proposed expenditures.

AGN's proposed opex is 30 per cent higher than actual spending in the current access period. Noting more than half of this is attributed to a proposed change in capitalisation, benchmarking analysis indicates that AGN's existing opex levels may already reflect inefficiencies relative to its comparators. The data from Economic Insights reflects average spending from 2015 to 2019 while AGN's opex has increased since then, so updated analysis may be useful. AGN's statement that it had achieved efficiency gains over 2015 to 2019, and that 2021 spending is consistent with that in 2019[6], does not appear to be supported by the general increasing trend in actual opex. This trend is further apparent in the additional $12 million in AGN's updated base opex to reflect the half year 2023 allowance.[7] Similar statements are made by MGN and our observations are the same, noting that MGN appears to be even less efficient based on the Economic Insights comparisons.

Our other observation with respect to MGN's opex relates to spending in the current period, which was around 10 per cent lower than the approved allowance. This persistent variance over the period warrants an explanation as it suggests a material forecast error in assessing MGN's prior base year or step changes, or the gaming of carryover mechanisms. Investigation of these issues may have a bearing on the AER's assessments for the forthcoming period.

Supporting vulnerable customers under networks' proposed Priority Services Program is admirable. While the proposed opex amounts are not especially large, they seem to be more discretionary in nature rather than amounts reflecting the lowest sustainable cost of delivering pipeline services under rule 91 of the NGR. Reflecting this point, and to its credit, AusNet states that it will undertake elements of this program even if the AER rejects associated funding.[8] Noting that the AER does not approve or reject individual opex activities, AusNet, as well as MGN and AGN, should be expected to fund these activities themselves. This aside, the proposed spending requires further justification as the support under this program is likely to be already provided by the businesses, and dedicated teams would not be required given the established programs of energy retailers and many community organisations.

MGN's proposed $408 million of capex for mains replacement is substantial. MGN's justification for this spending is to address safety and integrity. While we have not examined the full extent of MGN's supporting information or raised specific issues with MGN in consultation to date, we make the following observations:

- the safety and integrity of network assets obviously has critical consequences for the community in terms of injury and risk to life. However, presenting a broad justification of safety should not deter the AER from requiring businesses to present robust, quantitative cost-benefit assessments of different levels of risk.
- MGN also appears to partly justify this work in order to "ready our network for 100% renewable hydrogen in the future"[9] as well as greenhouse gas benefits, noting its replacement program to date has "reduced our reported scope 1 emissions by 35,000 tonnes CO2-e pa (or 15%) compared to 2017 levels."[10] It is not clear how either of these additional justifications affect the proposed scope of works or their expected benefits to consumers. As above we have concerns about the prudence of any spending for hydrogen readiness.
- The AER should seek further information on MGN's mains replacement volumes relative to forecast risk measures, both in the presence and absence of the proposed work program. Information presented in MGN's distribution mains and services strategy does not appear to present a consistent

[6] AGN, *Five year plan for our Victorian distribution network*, July 2022, p. 77.
[7] AGN, *Revisions to our five year plan for our Victorian distribution network*, September 2022, p. 19.
[8] AusNet, *Access Arrangement Information*, July 2022, p. 70.
[9] MGN, *Five year plan for our Victorian distribution network*, July 2022, p. 4.
[10] ibid., p. 10.

or complete case around historic asset deterioration, nor how spending would address this. For example, there appears to be a step increase in low pressure leak incidences since 2019, whereas progressive asset deterioration might suggest a longer-term trend increase. Data presented on cast iron mains fractures suggest improvements, rather than declines, in asset performance over time[11], without indication of what might be an acceptable or maximum legal failure rate. We could not see data presented for other failure modes or risk measures.

- Attachment 9.6 does not publicly disclose MGN's unit rates for these works, however states there is a 28 per cent increase from the "current AA benchmark".[12] It is not clear what this benchmark is, why it is a relevant comparison or why a 28 per cent increase would still represent efficient unit rates. The proposed unit rates should be validated against measures of actual efficient spending, including by MGN's peers.

- To the extent the scope of works reflects Victorian or other legislative safety obligations, the AER should seek explicit confirmation from Energy Safe Victoria and other safety regulators that these works are prudent, and that the associated costs (including in the face of apparent unit cost increases) are more than offset by their expected safety benefits to the community. MGN has already demonstrated that there is some discretion in this program of works, with a 14 per cent reduction in proposed volumes between its Draft Plan and final proposal.[13] MGN has further reduced this proposed spending by 4 per cent in its more recent addendum.[14] The AER should test how much further this can be reduced in light of clearly defined safety, risk or legal limits. Where such hard limits do not exist, the onus should be on MGN to quantify net benefits to consumers and the community of its proposed works.

Overall, we would expect to see justifications and supporting data that is proportionate to the $333 million in proposed capex on low pressure mains that MGN expects customers to pay, particularly when the bulk of these assets face a very high risk of becoming stranded.

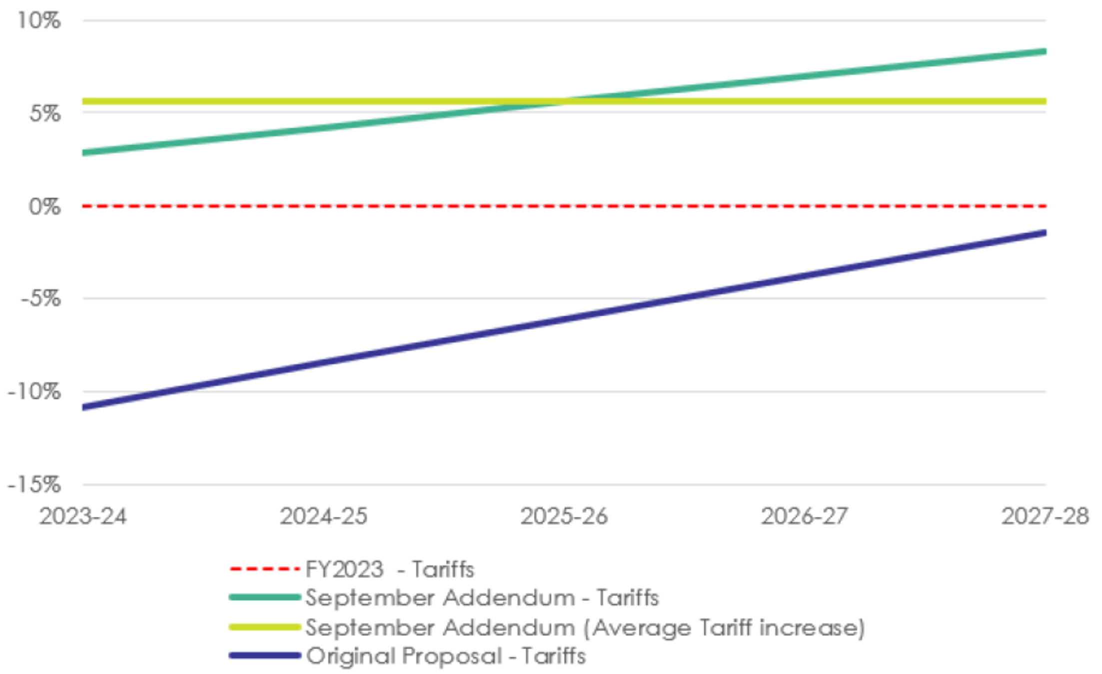
Price impacts should be clearly communicated

As noted above, customers are facing unprecedented cost pressures which are expected to deteriorate in the coming 6 to 12 months as current wholesale pricing eventually flows through contract markets, combined with broader inflation and interest rate rises.

For these reasons it is critical to understand, validate and communicate the approaches taken by the networks in terms of customer price impacts. Regulated networks typically communicate headline "price" changes in terms of smoothed aggregate revenue requirements for their business, which is already an abstraction from what changes flow through to retail prices and billing. As we have raised in prior network determinations, there is a role for the AER to prescribe how headline calculations are presented, in order to provide stakeholders with familiarity and avoid inconsistency across different regulated networks. For example, AusNet's proposal addendum quotes "a small real price increase for customers of around 5.5% on average over the period"[15], with further graphical representations of percentage changes (see below) and "smoothed revenues per customer". These representations conflict with more useful information on average nominal (network) bills over the access period for different customer types that are listed immediately afterwards.[16]

[11] MGN, *Attachment 9.7 - Distribution Mains and Services Strategy*, July 2022, pp. 20-21.
[12] MGN, *Attachment 9.6 – Unit Rates Report*, July 2022, p. 39.
[13] MGN, *Five year plan for our Victorian distribution network*, July 2022, p. 93.
[14] MGN, *Revisions to our five year plan for our Victorian distribution network*, September 2022, p. 22.
[15] AusNet, *Access Arrangement Information - Addendum to proposal*, 2 September 2022, p. 2.
[16] ibid, pp. 45-6.

Figure 9.1: Real Price Increases



Source: AusNet

The headline customer impacts for AGN and Multinet are presented much more succinctly e.g. "price increase on 1 July 2023 of 1% (after inflation) followed by price increases of 1% plus CPI for the remaining 4 years".[17]

The AER should also validate and monitor other potential price pressures

We recommend the AER explore the following in making decisions around price paths, tariff structures and in broader communications of customer impacts:

- Consider different X factor values in the context of managing total retail price trends, not just for the network component of bills in isolation. Gas commodity prices as well as electricity pricing will influence affordability for customers for the foreseeable future, with expectations these will ease during the forthcoming access arrangement period. Some consideration should be had for vulnerable customers who are likely to have different consumption profiles and hence total bill impacts than the 'average' customer.
- We question how or whether the current high levels of inflation (e.g. 6.1 per cent to the recent June quarter CPI) will flow through all network prices, including for the Victorian gas businesses. Inflation values of this order do not feature in the network PTRMs or customer pricing assessments.
    - We understand that a 'lagged' CPI will apply in the form of control. A CPI of around 6 per cent for 2022, when combined with the networks' X factors would see network prices increase on 1 July 2023 by up to 9 per cent in the AusNet area.
    - We also expect the current high values of inflation to flow through to opening asset values (and eventually prices) for the forthcoming access period, however again we have not identified above-trend CPI values in any of the asset or revenue models of the businesses.
- As pricing affects demand forecasts, the AER should validate whether higher retail prices on the back of more recent commodity and retailer contracting costs, as well as in response to increasing cost of living pressures, will encourage higher rates of gas switching, energy efficiency and self-generation options (PV as well as batteries) than assumed in the networks' proposals.

[17] MGN, *Revisions to our five year plan for our Victorian distribution network*, September 2022, p. 4

- Businesses regulated under a weighted average price cap are intentionally faced with volume risk, hence will revenue maximise via efficient price discrimination, including increasing prices on tariff components or for customer types that are less price responsive.
    - Multinet and AGN state that they are "proposing to maintain the same allocation of costs and pricing structures to all customers" hence all customers will face the same average change in their distribution charges.[18] However this appears to apply to 2023 only, and refers to estimated annual bill amounts not prices, which depend on assumed consumption volumes.
    - Given the general policy intent to switch away from gas, the AER should monitor for perverse outcomes where customers face stable or even increasing bills in spite of actively reducing their consumption. Vulnerable customers in particular are likely to be penalised where they have little capacity to benefit from energy efficiency measures or afford upfront costs of appliance switching.
- Further on tariff structuring, we note the networks propose new abolishment fees of up to $950. We have concerns these are a de facto exit fee, with implications on recovery of sunk costs and accelerated depreciation. The AER should explore the circumstances in which abolishment is necessary or a customer choice, and in either case ensure this is appropriately communicated to customers. Exit fees represent a barrier to switching and customers should be informed of cheaper options to electrify and avoid paying fixed service charges, for example by opting to simply disconnect rather than have services and meters permanently removed. The cheapest switching options must be communicated to customers.

We welcome the opportunity to discuss this submission in further detail with the AER. Please contact me on 03 9060 1361 or Travis.Worsteling@energyaustralia.com.au

Yours sincerely

Travis Worsteling
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[18] Initial proposal – AGN pages 137-8; MGN initial proposal, pages 140-1.