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**PIAC submission to the AER's draft determination for
Jemena Gas Network**

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Introduction

The Public Interest Advocacy Centre

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit law and policy organisation that works for a fair, just and democratic society, empowering citizens, consumers and communities by taking strategic action on public interest issues.

PIAC identifies public interest issues and, where possible and appropriate, works co-operatively with other organisations to advocate for individuals and groups affected. PIAC seeks to:

- expose and redress unjust or unsafe practices, deficient laws or policies;
- promote accountable, transparent and responsive government;
- encourage, influence and inform public debate on issues affecting legal and democratic rights;
- promote the development of law that reflects the public interest;
- develop and assist community organisations with a public interest focus to pursue the interests of the communities they represent;
- develop models to respond to unmet legal need; and
- maintain an effective and sustainable organisation.

Established in July 1982 as an initiative of the (then) Law Foundation of New South Wales, with support from the NSW Legal Aid Commission, PIAC was the first, and remains the only broadly based public interest legal centre in Australia. Financial support for PIAC comes primarily from the NSW Public Purpose Fund and the Commonwealth and State Community Legal Services Program. PIAC also receives funding from NSW Trade & Investment for its work on energy and water, and from Allens for its Indigenous Justice Program. PIAC also generates income from project and case grants, seminars, consultancy fees, donations and recovery of costs in legal actions.

Energy + Water Consumers' Advocacy Program

This program was established at PIAC as the Utilities Consumers' Advocacy Program in 1998 with NSW Government funding. The aim of the program is to develop policy and advocate in the interests of low-income and other residential consumers in the NSW energy and water markets. PIAC receives policy input to the program from a community-based reference group whose members include:

- Council of Social Service of NSW (NCOSS);
- Combined Pensioners and Superannuants Association of NSW;
- St Vincent de Paul (NSW);
- Ethnic Communities Council NSW;
- Retirement Villages Residents Association;
- Physical Disability Council NSW; and
- Affiliated Residential Park Residents Association.

1. Introduction

PIAC thanks the Australian Energy Regulator (AER) for the opportunity to provide comment on its draft decision for Jemena Gas Network's (Jemena) access arrangement (the draft decision). The draft decision is part of the AER's process to set Jemena's weighted average price cap for five years from 1 July 2015.

1.1 The AER's draft decision

PIAC broadly supports the AER's draft decision for Jemena. PIAC notes that if the draft decision was made final, Jemena would be able to recover total revenue of \$2.447 billion (nominal) over the five year regulatory period.¹ This total is around 15% less than the revenue requirement put forward in Jemena's initial proposal to the AER (\$2.933 billion).²

The key differences between Jemena's proposal and the AER's draft decision relate to capital expenditure and the weighted average cost of capital (WACC). The draft decision grants Jemena total capital expenditure (capex) of \$919 million over five years, 19% lower than Jemena's initial proposal of \$1.13 billion. The AER's draft decision also grants Jemena an allowed WACC of 6.80%, compared to Jemena's proposal of 8.67%.³

If implemented, the draft decision would see real weighted average tariffs for consumers decrease by 23.4% in the first year of the determination, and then decrease by 2.1% per year, in real terms, for the next four years.⁴ PIAC believes that these price levels are in the long-term interests of consumers, as they reflect the efficient cost of providing gas network services and place downward pressure on the cost of essential energy services. Nonetheless, PIAC wishes to make specific comment on a number of issues related to the AER's deliberations, as outlined below.

1.2 Counter proposals from Jemena

In response to the AER's draft decision, Jemena has made a revised proposal. This submission responds to both the AER's draft decision and the revised proposal from Jemena. It responds to two key aspects of Jemena's revised proposal, specifically:

- the WACC; and
- Jemena's proposed price path over the five-year regulatory period.

In addition, this submission discusses Jemena's consumer engagement activities as part of this price determination process, including PIAC's experience as a member of Jemena's customer council.

¹ AER, 2014, *Overview: Draft Decision for Jemena Gas Networks (NSW) Ltd access arrangement 2015-10*, 8.

² AER, 2014, *Fact sheet: Draft decision Jemena Gas networks (distribution) 2015-20*, 1.

³ Jemena, 2015, *2015-20 Access Arrangement*, 95.

⁴ AER, above n 1, 8.

2. Weighted average cost of capital (WACC)

The WACC is a key driver of final network prices. In its initial submission to the AER, Jemena proposed a WACC of 8.67% per annum.⁵ Jemena noted that this is down from 10.43% in the 2010-15 determination. The AER rejected this proposal and made a draft determination of 6.8%.⁶ In its revised proposal, Jemena has not accepted the AER's draft determination. Instead it has amended its proposal to reflect changes in market conditions since it made its initial proposal. The revised proposal is for a WACC of 7.15%.⁷

As part of the Better Regulation reform program, the AER developed a Rate of Return Guideline (the Guideline), which outlines the AER's preferred methodology for calculating a WACC. The Guideline was published in December 2013.⁸ Jemena's initial pricing proposal noted that in developing the Guideline, the AER 'consulted widely with consumer groups, network businesses, investors, banks rating agencies and other stakeholders'.⁹

PIAC made a number of submissions to the development of the Guideline. While the final Guideline was not totally consistent with PIAC's position, the process to develop it was rigorous and the result represents an improved outcome for consumers. Given the Guideline was developed recently and through a transparent and inclusive process, PIAC takes the view that all networks (and consumers) should accept the outcome and propose a WACC that complies with the Guideline.

Jemena's revised proposal notes that Jemena considered the Guideline 'but—just like the AER's draft decision—recognise that it is not binding'.¹⁰ The key area in which Jemena's revised proposal is not consistent with the Guideline relates to the method for estimating the cost of equity. Jemena argues that the AER has erred in seeking to 'pick a winner' from amongst the available models for estimating the cost of equity. Instead, Jemena argues that the four available models should all be used, and an average taken of the results they produce.

PIAC notes that that 'winner', the Sharpe-Lintner CAPM, is designated as the foundation model in the Guideline for calculating the cost of equity.¹¹ Accordingly, PIAC submits that the AER should follow the Guideline in determining Jemena's final WACC. PIAC takes this view for two reasons. Firstly, PIAC believes that determining a WACC using the Guideline will result in allowances—and final prices—that are closer to efficient levels than would be the case if the Guideline was not followed.

Secondly, PIAC believes strongly that the integrity of the process to develop the Guideline should be respected. That is, given the generally high quality of the process that developed the Guideline, it would not be appropriate to deviate from the result at such an early stage. For these reasons, PIAC submits that the long-term interests of consumers is best served by the AER determining a WACC that is consistent with the Guideline. Accordingly, PIAC recommends that the AER determine a final WACC for Jemena that is consistent with the Guideline. Given Jemena

⁵ Jemena, 2014, *Jemena Gas Networks (NSW) Ltd 2015-2020 Access Arrangement Information*, 92.

⁶ Jemena, above n 3, 95.

⁷ Ibid, 100.

⁸ Ibid, 95.

⁹ Ibid.

¹⁰ Ibid.

¹¹ AER, 2013, *Better Regulation: Rate of Return Guideline*, 13.

has updated its proposal to reflect changes in market conditions, the AER should also consider the appropriateness of making a similar update in its final decision.

PIAC also notes that many of the comments contained in its submissions to the review of NSW electricity distribution network prices in relation to the rate of return are relevant to the determination of a WACC for Jemena. PIAC, therefore, provides a copy of that submission as Attachment 1.¹² The most relevant section is pages 33 to 47.

Recommendation 1

PIAC recommends that the AER grant Jemena a WACC that is consistent with the approach and parameter values from the Rate of Return Guideline.

3. Proposed price path

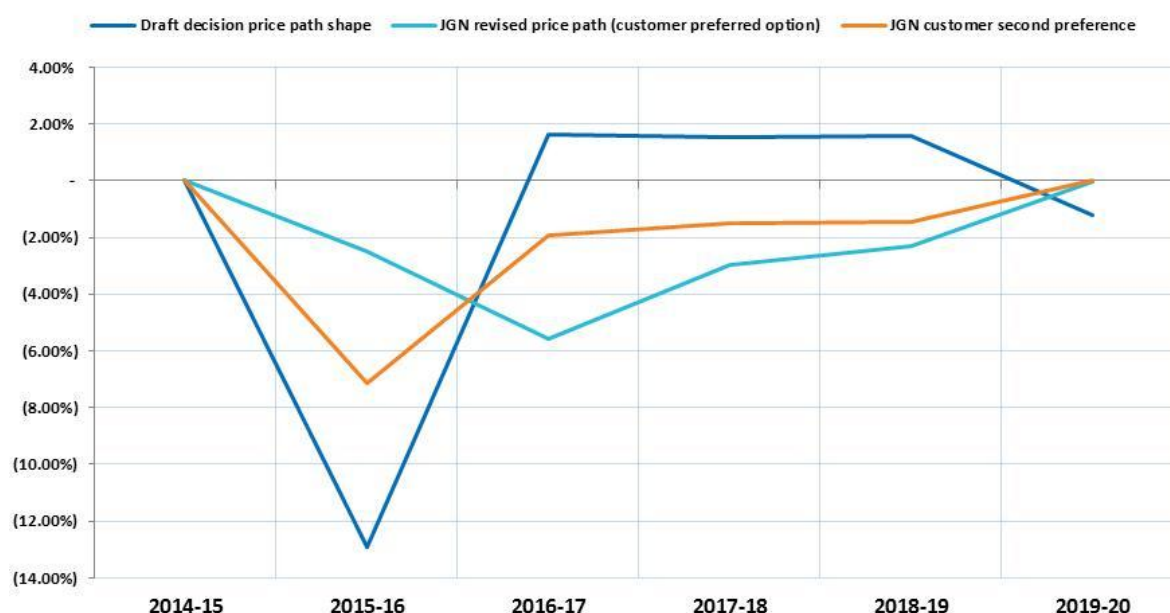
A key part of Jemena's strategy over the period covered by the current AER process (2015-20) is to set network prices to offset the impact of expected increases in wholesale gas prices. Jemena's hope in doing so is that retail prices will remain flat (or even slightly down) in real terms, meaning gas remains more competitive with electricity. Competitiveness is important to Jemena because gas is seen as a 'fuel of choice'. (Although, as PIAC has noted repeatedly, many low-income and vulnerable consumers have no choice about whether to use gas. In particular, renters have no say in whether their cooking or water heating appliances use gas or electricity.)

PIAC supports this approach. In PIAC's experience, low-income and vulnerable residential consumers prefer price stability over sharp decreases followed by sharp increases. Jemena describes this preference for price stability as 'a clear customer preference'.¹³ As noted above, the AER's draft decision gives a Jemena network prices that drop significantly in year one and then decline very gently in years two to five. However, when combined with Jemena's predictions for the wholesale gas price increases, the forecast retail price path becomes extremely lumpy. This is illustrated in Figure 10-1 below, from Jemena's revised proposal. Accordingly, Jemena has proposed an alternative, smoother price path. Jemena consulted its Customer Council in relation to its proposed price path. This issue is discussed further below, under Consumer Engagement.

¹² PIAC, 2015, *A missed opportunity?*, pp 33-47. Available at: <http://www.piac.asn.au/publication/2015/02/missed-opportunity-submission-australian-energy-regulator's-draft-price-determin>. See also PIAC, 2014, *Moving to a new paradigm*, pp 67-93. Available at: <http://www.piac.asn.au/publication/2014/08/newparadigm>.

¹³ Jemena, above n 3, 110.

Figure 10–1: Average residential customer estimate real gas bill percentage change¹⁴



As previously stated, PIAC supports Jemena’s intention in keeping retail household prices stable (and recognises why this is good for Jemena’s business). However, PIAC notes that Jemena’s proposed price path is based on forecasts for wholesale gas price around which there is enormous uncertainty. Indeed, PIAC believes that the task of forecasting wholesale gas prices in coming years, in order to design a smooth retail price path, is not just difficult, but virtually impossible. If wholesale prices were not to increase as fast as projected, PIAC would favour a price path closer to that in the AER’s draft decision, as consumers would see bills become lower sooner. As a result, PIAC recommends that the AER use its own expertise and forecasts, in concert with the material submitted by Jemena, to design a price path that strikes the appropriate balance between setting prices at efficient levels and providing price stability over the medium term. PIAC acknowledges the difficulty of this task.

Recommendation 2

PIAC recommends that the AER determine a price path for Jemena that balances the setting of efficient prices with price path stability.

4. Consumer engagement

PIAC has been a member of Jemena Gas Network’s Customer Council since its inception. Throughout that time, PIAC’s experience with Jemena has been extremely positive. Jemena has shown a commitment to inform and consult with customers and its Customer Council on matters of substance. Jemena has also sought to help its own employees better understand the experience of low-income residential consumers in relation to energy affordability and how Jemena is part of that picture.

¹⁴ Ibid.

In preparing its revised proposal to the AER, Jemena consulted its Customer Council in relation to the price path to be contained in that proposal. Members of the Customer Council were given two options for the revised proposal and asked to select which they preferred. The Council was told that the choice they were being presented with was a genuine and meaningful one—the decision of the group would be presented to the AER as Jemena’s preferred price path. The decision of the Customer Council is shown in Figure 10-1 above, with the chosen option labelled as ‘customer preferred option’ and the alternative labelled as ‘customer second preference’ (that is, second preference out of two options).

PIAC applauds Jemena for having given consumer advocates and representatives the option to have such meaningful impact into a regulatory proposal. PIAC hopes that having signalled this intention, Jemena is able to increase the sophistication of such engagement in the future. When given longer to understand and consider complex options, PIAC is confident that consumers, and their representatives, will be able to make valuable contributions to issues with a wide variety of options and different implications.

PIAC also notes that Jemena has been critical of the AER’s own efforts at consumer engagement, asserting that there were ‘fundamental gaps in the AER’s attempts to involve consumers’ in [Jemena] price review process’.¹⁵ PIAC does not disagree that the AER could have done more to engage with consumers as part of this process. However, PIAC believes that consumer engagement is most important in relation to deviations from the approach to energy network regulation set out in the Better Regulation Guidelines. Where the AER is seeking to follow a framework that was developed with extensive consumer input, it is less important that consumer preferences be re-examine and re-affirmed at every turn.

Nonetheless, PIAC recommends that the AER examine ways in which it can improve its own consumer engagement. Where the AER better understands consumer preferences, PIAC submits it will be able to make more informed regulatory determinations that better reflect the wishes of consumers of monopoly services.

Recommendation 3

PIAC recommends that the AER examine ways in which it can improve its own consumer engagement practices.

5. Conclusion

Once again, PIAC thanks the AER for the opportunity to provide comment on the draft decision. PIAC submits that in making its final decision, the AER should not deviate from an approach that sees the WACC calculated in a manner that is consistent with the Guideline. PIAC welcomes Jemena’s efforts to design a price path that will result in stable retail prices for households who use gas. While forecasting future gas prices is an enormous challenge, PIAC hopes the AER will attempt to make a determination that balances the need for efficient prices with consumer preferences for stable prices. PIAC has been, and remains, complimentary about Jemena’s efforts to engage and consult with its consumers. PIAC believes that there is scope for the AER to improve its own practices in this area, although the absence of immediate action in this area is not a sufficient basis for altering its approach to setting prices.

¹⁵ Ibid, xv.