No Shocks AA Proposal

Submission to:

Australian Energy Regulator

From:

Uniting Communities

(part of UnitingCare network)

Regarding:

Australian Gas Networks Access Arrangement Proposal for Victoria /Albury

Note: Uniting Communities is South Australia's first accredited Carbon Neutral organisation/business.

Contact:

Mark Henley

MarkH@unitingcommunities.org

Background – Uniting Communities

This submission is prepared by Uniting Communities, a large Uniting Church based community service organisation in South Australia, providing about 100 different services. Uniting Communities has prepared this submission on as a member of the UnitingCare Australia network, over 650 different organisations, separately incorporated; providing services in just about every geographic corner of Australia.

Our input is driven by the experiences of thousands of individuals, families and communities with whom we work through services including financial counselling, aged care services, disability services, homelessness support services, Lifeline and many more.

Uniting Communities undertakes energy policy development and advocacy on behalf of the national UnitingCare network, who has proposed the development of a "DNA approach" to network regulation, where DNA is an acronym for "Deliberation, Negotiation and Agreement." This perspective underpins our submission.

Overview of this Access Arrangement Proposal

We believe that this is one of the first regulatory proposals to seriously demonstrate consumer focussed engagement that has been subsequently integrated into the final proposal lodged with the Regulator. For us this is a 'no shocks' regulatory proposal, an approach and attitude that we hope sets the approach for future network business regulatory proposals. It is a proposal prepared with significant, meaningful consumer and other stakeholder engagement.

While there are a couple of comments that follow that are not completely supportive of what AGN has proposed, we expect that our comments will come as 'no shock' to them.

We commend AGN on this Access Arrangement proposal and commend them on their keenness to engage with stakeholders, including consumers and to do so in a consistent and trust building manner.

<u>Overview</u>

Throughout the proposal AGN has been steadfastly consistent in relating all topic areas to their three core objectives, which they express as:

- *"Delivering for Customers – which means ensuring public safety and the provision of high levels of network reliability and customer service;*
- *A Good Employer – which means ensuring the safety of our employees (including contractors), ensuring employees are motivated to achieve our Vision and receive appropriate training; and*
- *Sustainably Cost-Efficient – which means undertaking the required work within the allowances set by the AER while growing the network in a prudent and efficient manner."*

While we could 'nit-pick' about minor aspects of these core objectives, they are however appropriate to the business and diligently maintained throughout the proposal. We are left in no doubt that this business knows who they are and where they are heading. We cannot recall another regulatory proposal that has the stated core objectives so deeply embedded in a proposal, this is instructive to us and gives great confidence that the regulatory proposal is much more 'genuine' than 'ambit'.

Having a core objective of "delivering for customers" is important and supported, we believe that an essential part of delivering for customers is engaging with customers and customer representative groups in particular in developing policy and regulatory proposals. Indeed AGN has achieved this in developing their Access Arrangement proposal.

AGN summarises the "deliverables" of their proposal as follows:

> *"In particular, we intend to:*
>
> - *deliver an upfront 11% reduction in distribution prices (or tariffs) before inflation on 1 January 2018, with prices lower on average over the next AA period compared to current prices (see Chapter 14);*
> - *continue to deliver leading productivity performance, including by reducing total expenditure compared to the current AA period, collectively delivering a $23 million reduction in our costs across the next AA period (see Chapters 3, 7 and 8);*
> - *maintain current levels of reliability and customer service, which is consistent with the feedback we received during our stakeholder engagement program (see Chapters 5, 7 and 8);*
> - *introduce customer satisfaction measurement as a 'business-as-usual' key performance indicator, which will help continue to drive a change in our culture to be a genuinely customer-focused organisation (see Chapter 11);*
> - *improve the safety of our networks, primarily through the completion of the low-pressure mains replacement program, which is also consistent with feedback we received during our stakeholder engagement program (see Chapters 5 and 8);*
> - *continue to grow our networks, with around 16,000 new customers expected to be connected to our Victorian and Albury networks each year (almost 80,000 new customers over the next AA period) (see Chapters 8 and 13);*
> - *drive continuous improvement in employee/contractor safety, undertake regular employee engagement/satisfaction surveys and ensure all employees receive (at least) the training required to efficiently deliver on the requirements of their job; and*
> - *improve and strengthen the incentives for the business to pursue prudent and efficient expenditure whilst maintaining high levels of network safety, reliability and service (see Chapter 11)."*

These are solid outcomes for consumers. It may be that there is some scope for better outcomes for consumers, we leave this to the AER to determine utilising their technical capacity. We are supportive of this set of outcomes and from our perspective regard them as being fair and responsible.

We challenged AGN about their growth projections of 80,000 new customers over the AA period, considering this to be overly ambitious in a period of increasing carbon emission concern and noting high wholesale east coast gas market prices. AGN responded in detail citing their region as experiencing high residential growth, one of the highest in Victoria. They also said that Victoria has higher gas use than other Australian states, and that this is likely to continue, at least for the period of this Access Arrangement. Reforms in the east coast gas market, they expect, will also serve to keep wholesale prices in check and maintain gas as a "fuel of choice." AGN's table 7.5 summarises forecast customer growth, as well as showing increased incremental costs to customers of about 1% over the 2018-22 regulatory period.

Table 7.5: Output Growth

Incremental Cost per Customer	2018	2019	2020	2021	2022	Total
Net Customer Growth	8,176	13,101	13,249	13,472	13,695	61,692
Incremental Cost per Customer ($2017)	23.0	23.1	23.1	23.2	23.3	
Total ($2017, million)	**0.4**	**0.7**	**1.0**	**1.3**	**1.6**	**5.0**

Note: Totals may not add due to rounding.

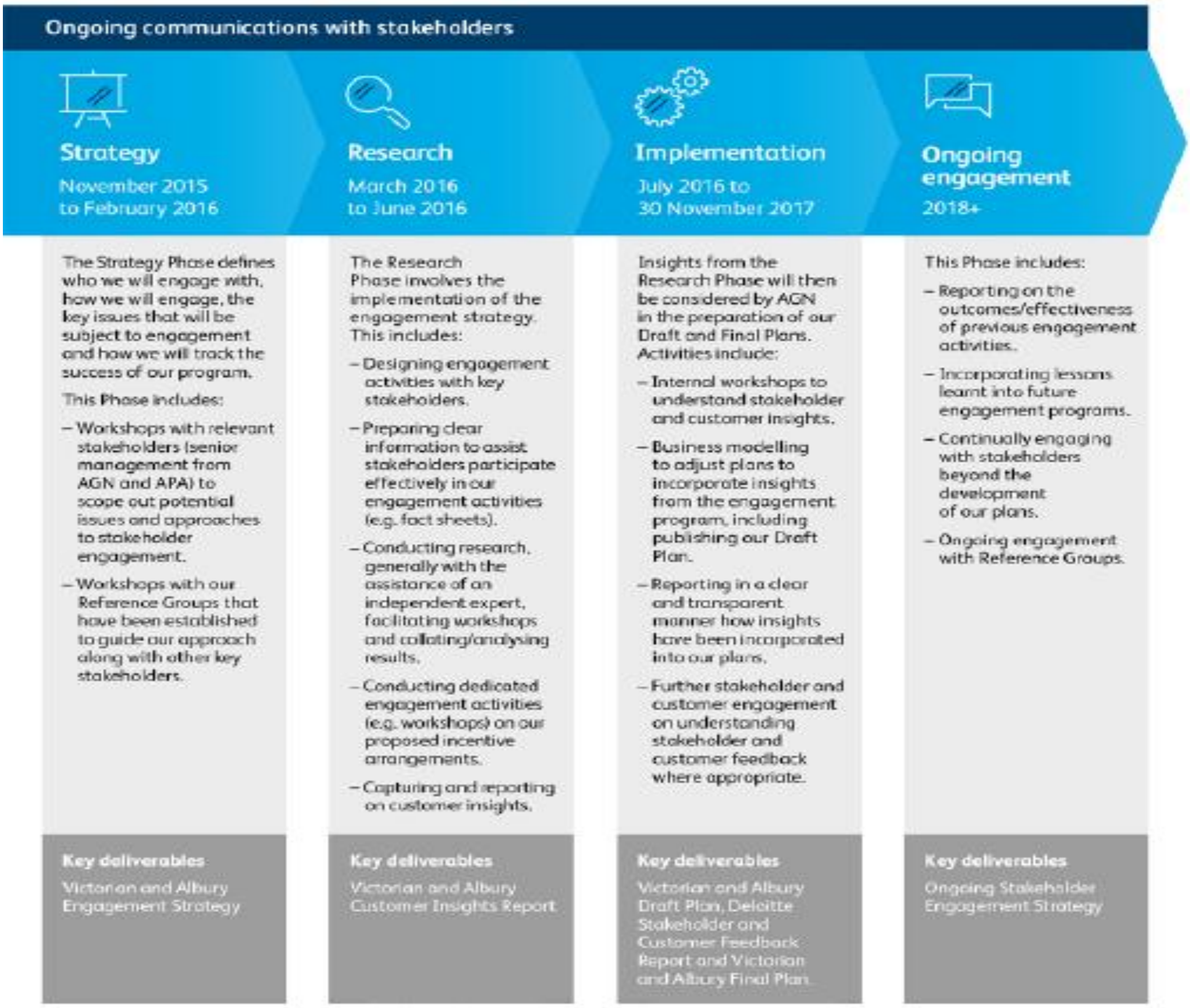
The outcomes proposed by AGN passes the 'reasonableness test'.

Stakeholder engagement

Note that we have been actively involved in AGN's consumer engagement in South Australia and have maintained engagement through the Victoria – Albury proposal development, albeit at more of a distance. We observe that AGN has improved significantly on their stakeholder engagement in Victoria – Albury compared to South Australia, due to starting engagement earlier and having the new (for SA proposal) senior management team more established.

AGN's figure 5.2 below summarises their stated approach to stakeholder engagement.

Figure 5.2: Our Approach to Stakeholder Engagement



We make four observations about our experience of this engagement approach

1. “Promise to the public”
2. Reasonable lead time
3. Release of Draft Plan
4. Delivery of approach.

<u>Promise to the Public</u>

We have been critical of other network businesses who have claimed to apply the IAP2 spectrum in their engagement with stakeholders, including consumers, but who have failed, in our opinion, to consider the ‘promise to the public’ aspects of that IAP2 model. While not directly aligning their approach with IAP2, AGN have provided clear commitments, their term is “deliverables” to the public. We think this approach to identifying key promises to the public is a strength of the AGN Access Arrangement proposal and we would regard it as ‘best practice’ current Australian energy network regulatory process.

Reasonable lead time

While probably not front of mind in considering aspects of good consumer engagement, start time for network business is crucial in both enabling time for trust to be built with stakeholders and consumers and enabling a enough time for deliberation, debate and discussion to occur in a meaningful way. By starting their stakeholder engagement process for Victoria and Albury earlier than they did to South Australia, AGN has indicated that they are applying 'continuous improvement' processes to themselves and being respectful of stakeholders who need to see that their efforts will be recognised. Adequate lead time is essential to achieve this.

Release of draft plan

By releasing a draft plan well before lodgement with the AER that encapsulated the main intended elements for their access arrangement proposal, AGN have lived up to the promise they gave to stakeholders that there would be "no surprises" in the AA proposal that they lodged.

For Uniting Communities, the early release of a draft plan is exactly the sort of process that we have envisaged in our "DNA approach" to network regulation. We suggest that this approach has many benefits, but it will take a little time to realise the full extent of these for all parties, particularly end consumers.

We've also worked closely with ElectraNet who have undertaken a similar process in releasing a Preliminary Revenue Proposal prior to lodging their regulatory proposal.

We strongly encourage the AER to recognise the benefits of this approach and the leadership role that AGN (and couple of other network businesses) are playing in having the courage to trial early disclosure / 'no shock' approaches.

Delivery of Approach

A major risk for any business in specifying an approach that they will take, particularly where it provides benefit to customers, is that will fail to deliver on the approach they 'flagged.' We do not consider that AGN falls into this category, rather from our perspective they have followed through on the approach that they specified at the start of their consumer engagement and we believe that the AGN proposal, as lodged, reflects the approach promised and the approach delivered.

Opex

The only operating expenditure costs that we wish to comment on is the proposed expanded marketing program, which AGN proposes to be a "step change."

They argued that marketing is an essential operating cost for this reasons summarised in the extract below:

> *"Marketing is required because natural gas is a fuel of choice, reflecting that there are readily available and low cost substitutes for all residential and most business uses of natural gas. As a result, and like most other businesses, we are required to market (or sell) the benefits of natural gas to customers. The competitive pressures faced by our business are*

expected to increase as a result of, for example, increasing penetration of renewable electricity and storage options."

We agree that marketing is a legitimate operating expenditure, provided it is cost-effective with a high likelihood of reducing unit costs across the customer base as more customers, industrial and households, use gas. We have no qualms with a modest marketing budget and applaud the gas businesses in Victoria for collaborating on developing a shared marketing program.

However we remain unconvinced that marketing expenditure is a 'step change'. Step changes are used for a new or unexpected expenditure; marketing is neither new nor unexpected, rather it is a standard cost for most businesses and has been part of AGN's South Australian operation for some time. We have discussed this issue with AGN, and they have said to us that marketing for gas use is a comparatively new approach in Victoria, even though it's been part of the South Australian operation of AGN for some time, they also advise that the partnership for marketing is a new development and consequent warrants a step change status. AGN has also provided the data presented in their table 7.5, below, which shows a very modest increase in "incremental cost per customer" across the regular period with the expectation of significant new customer growth. With longer term costs per customer falling with a larger customer base.

Table 7.5: Output Growth

Incremental Cost per Customer	2018	2019	2020	2021	2022	Total
Net Customer Growth	8,176	13,101	13,249	13,472	13,695	61,692
Incremental Cost per Customer ($2017)	23.0	23.1	23.1	23.2	23.3	
Total ($2017, million)	**0.4**	**0.7**	**1.0**	**1.3**	**1.6**	**5.0**

Note: Totals may not add due to rounding.

We have also discussed with AGN the substantial forecast for new customer growth, suggesting that a 67% growth over five years is an ambitious forecast. They have convinced us that the projections are reasonable because AGN is the supplier in high housing development growth areas of Melbourne suburbs and in some growing regional areas. We accept the veracity of the information that AGN has shared with us.

As legitimate as these arguments are, we do not regard that marketing should be regarded as a 'step change,' that is a significant new expenditure for something new or unexpected. Rather the modest shared advertising and marketing program should be accepted as part of ongoing operating expenditure for each of the Victorian gas distribution businesses.

Capex

Table 8.13 from the AGN Access Arrangement proposal includes the following breakdown of forecast capex. It is encouraging that new capital expenditure is forecast to be lower at the end of the period than at the beginning and that expenditure items are significantly lower for the last year of the period than for spending during years earlier in the period. We note mains replacement has been a significant program across AGN's Victorian business for a number of years, and we are heartened that expenditure in this area is much lower for 2018-22, reflecting the end of a significant process. We certainly expect that customers will receive the benefit from mains replacement with greater efficiency of service and less gas loss leading to lower real costs for customers. The other expenditure that we have considered is IT, which has very high expenditure in 2019, dropping away significantly in subsequent years. We accept that one-off investment can and should lead to more efficient operation of the business once the new IT system and processes are bedded down.

We do not have technical expertise to forensically examine the capex elements, we leave that to the AER, however the overall approach seems reasonable to us.

Table 8.13: Breakdown of Capex Forecast ($2017, million)

Capex Driver Category	2018	2019	2020	2021	2022	Total
Mains Replacement	35.4	37.4	37.4	35.0	8.6	153.7
Growth Assets	35.0	34.2	34.5	35.1	35.6	174.3
IT	11.5	24.2	16.5	5.2	6.1	63.5
Meter Replacement	7.6	7.6	7.6	5.1	5.1	33.2
Augmentation	5.7	9.3	7.4	3.5	2.1	28.0
Telemetry	0.3	0.3	0.3	0.3	0.1	1.2
Other Assets	4.7	6.5	11.5	8.1	4.0	34.8
Escalation	0.6	1.3	2.0	2.6	2.4	9.0
Overheads	11.5	11.9	11.8	11.4	10.8	57.3
Total	**112.3**	**132.6**	**128.9**	**106.3**	**74.8**	**555.0**

Note: Totals may not add due to rounding.

Inflation

AGN says;

> *"We consider the estimate of expected inflation to be one of the key outstanding issues to be resolved with the AER following our South Australian AA review process.*
>
> *We believe that the market-based approach provides the best estimate of expected inflation over the next AA period. This is primarily because the market-based approach is:*
>
> - *"correctly matched" with expected inflation reflected in the nominal rate of return on the basis that both estimates rely on the same market information; and*
> - *"jointly estimated on consistent terms" with the nominal rate of return as demonstrated by a comparison of actual real CGS yields and implied real CGS yields using the AER approach to forecasting inflation.*
>
> *As at September 2016, the market based approach would give rise to an estimate of expected inflation of around 1.6%.*
>
> *We have, however, assumed the AER approach of 2.39% in this Final Plan pending the outcome of further engagement with the AER and stakeholders on this important matter. We*

also note that the approach to estimating expected inflation is currently subject to legal review. We will continue to monitor this issue and update our approach, if required, once there is further clarity on this matter (including through engagement on our Final Plan).

We are keen to work with the AER to ensure that we adopt the best estimate of forecast inflation to set our revenue/prices over the next AA period."

We agree that inflation is a particularly important parameter with implications for return on capital, depreciation, Regulated Asset Base and incentive arrangements. We also agree that it is a matter that is currently subject to appeal. It is our expectation that the final rate of inflation for this AA period should be the subject of focussed and timely stakeholder and consumer engagement, once there is greater clarity about direction of the appeal processes and new data from the relevant sources.

Return on Equity

AGN as presented their proposed parameters in their table 10.2.

Table 10.2: Indicative AER Return on Equity

Parameters	Our Indicative Proposal
Risk Free Rate (Average of observed yields on 10-year Australian government bonds over agreed averaging period)	2.03% (Using a placeholder 20-day averaging period ending on 30 September 2016)
Equity Beta	0.7
Market Risk Premium (MRP)	6.5%
Return on Equity	6.58%

We are well aware that some of these parameters are under review in regard to other determinations, and we will obviously need to accept whatever decisions are made by due process. For the record we highlight that our response to merits review appeals for other decisions has been to include commentary on "gamma", which we argued should be set at 0.5, (if it is used at all) We maintain this position.

Incentive schemes - proposed network innovation scheme.

AGN says in their proposal:

We are proposing a scheme that is similar in its intent to the DMIS discussed earlier, which scheme allows electricity distributors to seek additional funding (generally through opex) to manage peak demand on the network instead of investing in network augmentation. The electricity distributors apply to the AER for amounts up to $1 million per year to invest in demand management (but only recover the amount they spend).

Consistent with stakeholder feedback, our starting point for designing the network innovation scheme (NIS) is the DMIS that the AER applies to electricity networks. Like the DMIS, under our proposed NIS:

- *the AER would approve projects that qualify for NIS funding before we commence them, having regard to agreed project criteria;*
- *AGN will be able to apply to the AER for amounts up to $1 million per year to invest in innovation;*
- *any approved expenditure on innovation is excluded from the operation of the EBSS and CESS; and*
- *AGN will only recover, through tariffs, amounts we have actually spent on approved projects.*

11.5.3.2. Criteria for the Network Innovation Scheme

In order to receive the funding, it is proposed that AGN is required to demonstrate that the use of the innovation funding meets the following criteria (which criteria are similar to that used by Ofgem to administer their equivalent innovation scheme):[117]

- *the project must have the potential to have a direct impact on our operations and involve the research, development or demonstration of at least one of the following: • a piece of new equipment, such as control and communications systems and software;*
- *a novel arrangement or application of existing network infrastructure;*
- *a novel operational practice directly related to the operation or safety of the network or improvement in customer service;*
- *a novel commercial arrangement; or*
- *a reduction to the carbon intensity of the gas distributed by the network;*
- *the project must have the potential to develop learning that can be applied by other gas distributors in Australia;*
- *the project must have the potential to deliver net financial benefits and/or improvements in our service to gas customers; and*
- *any intellectual property developed must be made available to third parties.*

AGN argues that innovation schemes in network businesses, including gas, in other jurisdictions are producing positive outcomes for customers and responding to broader public policy requirements including reduced carbon emissions.

"Innovation schemes are commonplace across most industries, including electricity distribution in Australia (through the DMIS) and electricity and gas distribution in the United Kingdom. Benefits of these schemes can include lower energy bills, improved environmental outcomes (our key focus), improved reliability and safety, better quality of service and societal benefits to low income earners. For example:

- *the H21 Leeds City Gate project is studying the feasibility of converting a natural gas network to 100% hydrogen, which will completely decarbonise gas supply;118*
- *Geneco, a business owned by Wessex Water, now upgrades biogas produced from anaerobic digestion in the Bristol sewage treatment works and injects it into the gas distribution network;119*
- *the New York Power Authority's 'Digital Avatar' project will yield USD2 billion in savings to customers through predictive analytics and integrated operations, thereby lowering the cost of the network and customer bills;120 and*
- *Ofgem has committed £44.6 million in funding toward smart grid pilot projects to boost the reliability of the United Kingdom's gas and electricity networks.*

These projects have been facilitated by a form of innovation allowance (or scheme) provided by the regulator that allows for collaboration between technology inventors, industry and consumers. These projects have changed industry culture and provided benefits to all participants, thereby promoting the long-term interests of consumers. This demonstrates the importance of innovation schemes in facilitating timely responses to changing market conditions and customer values."

This is another matter that we have discussed quite extensive discussions with AGN and agree with them that innovation is highly likely to be at the core of any successful business. We have also candidly expressed some cynicism about the propensity for innovation to be a "buzzword" across Australian businesses simply given the Prime Minister's frequent statements about the importance of businesses innovating.

We have however been convinced that AGN is serious about innovation, their recently released statement of proposed innovation is clearly not cynical and indeed, carefully researched and well thought through. Their recently released statement includes active exploration of use of hydrogen both as part of the carbon reducing gas fuel mix and also as an energy storage approach, utilising hydrolysis.

It is crucial that innovation lead to better outcomes for consumers particularly in the medium to long term while not imposing a significant burden short-term. We know that AGN fully support this approach and we believe their commitment to a rigorous innovation incentives allowance will include public sharing of results, this being a good indication of their 'goodwill' with regard to innovation development.

We support the concept of innovation incentives scheme and look forward to being part of further discussion about structuring the scheme to optimise likely consumer benefit.

Summary

Uniting Communities commends AGN on pioneering a "no shock" approach to this regulatory proposal. From our (non-technical) considerations we are strongly supportive of the approach that AGN has demonstrated, encouraged by their significant efforts to build and enhance stakeholder trust and we look forward to continuing to build a close and constructive working relationship with them, with the shared objective of the best possible outcomes for gas consumers.