ECA RESPONSE TO JEMENA GAS NETWORKS' (JGN) DRAFT PLAN FOR 2020-25

TRAC Partners

EXECUTIVE SUMMARY

KEY ISSUES "ON A PAGE"….

- JGN is earnest in its focus on consumer interests:
  - a mature customer engagement process for the 5 yearly access arrangement proposal
  - putting consumer interests at forefront of JGN's corporate and marketing strategy.
- Total revenue proposal (even without revenue handback) aligns with customer affordability concerns – 12% reduction across key customer classes. Reductions being proposed across multiple building blocks – lower rate of return, opex and actual capex
- JGN's case for shortening asset lives as one of the ways to manage managing an uncertain future for the network needs further development:
  - To demonstrate likelihood of stranding risk is more real now than 5 years ago
  - To assess pros and cons of all alternatives to manage the risk
  - To demonstrate that JGN is sharing some of the risk of stranded assets rather than it just being about the allocation of the risk between today's and tomorrow's customers

KEY FEATURES OF DRAFT PLAN THAT ALIGN WITH ECA'S OBJECTIVE

There are a number of high level features of the plan that align with ECA's objective:

Draft Plan Feature	Relevant ECA Objective
• Network component of average residential and commercial retail bills will reduce by 12% over the 2020-25 period (excluding handback of over-recoveries during 2015-20)	Long term consumer interest wrt price
• Smoothing of network bill for average coastal customer within the 10% side constraint	Long term consumer interest wrt price
• Sharing of price reductions across all customer classes	Long term consumer interest wrt price
• No compromise on prior service levels	Long term consumer interest wrt reliability and security of supply
• medium term approach to certain capex so as to reduce Regulatory Asset Base (RAB) growth	Long term consumer interest wrt price
• Operating expenditure efficiencies	Long term consumer interest wrt price and reliability and security of supply

However, there are areas for improvement or aspects where the case for alignment with consumer interests is yet to be made out…….

ECA'S KEY REMAINING QUESTIONS

- Can JGN provide further justification that shortening asset lives for future capex, as one means of responding to uncertainty around the long term future of the gas network, is more prudent than deferring a decision on this until 2025-30:
  - deferring will reduce the revenue requirement by $21m during 2020-25; and
  - deferring may not result in a significantly larger increase in bills for customers during 2025-30; and
  - deferring will enable more information to be available to assess whether stranded asset risk is real – particularly viability of hydrogen.
- If the likelihood of stranded asset risk is too real to not act now, could JGN more clearly demonstrate that:
  - All options for addressing this risk have been considered; and
  - JGN is sharing in the risk of future asset stranding risk, rather than it just being a risk sharing issue between intergenerational customers
- Could JGN more clearly outline the case for mandating boundary-only meters for new apartment buildings with centralised hot water systems – in particular, that limiting choice for customers will not lead to higher overall costs for consumers in all sized apartment complexes (if it reduces the level of competition)
- We would like JGN to explore alternative tariff arrangement options to encourage ongoing use of network - eg better tiering of usage charges the more the network is used by residential customers. But without making bills too complex.

BUILDING BLOCKS – SUMMARY OF ECA COMMENTS

Building Block	Key Issues	Importance
RAB Roll Forward	• While total actual capex between 2015-20 is in line with AER approved total, there are significant divergences in the line item allowances. Can JGN give further explanation of the reason for the divergences?	M
Forecast Capex	• We note consumers support not introducing an upfront contribution for all electric homes connecting to gas	L
	• We would like to get further clarity that the medium term approach to certain capex items will have no adverse impact on future customers than compared to a long term approach to investment.	L
	• We would like to better understand JGN's risk management approach given the divergences between 2015-20 capex line item allowances and the actuals for each line item – so that we have confidence in the capex forecasting process for 2020-25.	M
	• While the volume boundary metering strategy will reduce capex levels, could JGN more clearly outline the case for mandating boundary-only meters for new apartment buildings with centralised hot water systems – in particular, that limiting choice for customers will not lead to higher overall costs for consumers (if it reduces the level of competition)	M
	• JGN compares favourably against industry peers on most capex categories except connection costs. Further clarification on divergence on connection capex required given it represents 45% of total forecast capex	M

BUILDING BLOCKS – SUMMARY OF ECA COMMENTS

Building Block	Key Issues	Importance
Opex	• Favourably benchmarked against peers	L
	• Continuing with 0.5% opex productivity improvement plan	L
	• Important to share with consumers the savings from transformation program and sharing benefits with ongoing productivity index	L
	• Could JGN explain why expensing corporate overheads that were previously capitalised is in consumer's interests when it will increase charges in short term	M
Depreciation	• Shortening of asset lives for new assets (see slide 5)	H
Taxes	• Consistent with Australian Energy Regulator (AER) guidelines	L
Incentives	• Opex Efficiency Benefit Sharing Scheme to be updated to align with latest precedent	L
	• Capex Sharing Scheme (CESS) still to be developed but will be based on Victorian gas networks' schemes. ECA is keen to continue to engage with JGN on the scheme	M
Price path	• Smoothing of 2010-15 over-recovery return appears to be in consumers' interests • Query whether Sydney based CPI might be a more appropriate tariff variation index	L
	• 10% side constraint is consistent with regulatory precedent	L
Consumption & Connection Forecasts	• Justification for significant reduction in growth in new connections needs to be made clearer	M

ECA POSITION ON JGN'S STRATEGIC INITIATIVES

IMPROVING COST COMPETITIVENESS

- Overall, a plan that aims to deliver a 12% saving in the network component of the average residential and small business gas bill would appear to be in consumers' interests
- ECA's comments on the initiatives proposed to deliver the savings:

Cost Competitiveness Initiative	ECA Comment
Medium term approach to certain capex initiatives (as opposed to long term)	We would like to get further clarity that medium term approach to certain capex items has no adverse impacts on future consumers than compared with a long term approach to investment. Medium term approach would seem to be a better approach because: • If growth continues - impact on network component of average annual bill is negligible ($2) until 2040 • If network is in decline – bill will be $40 higher in 2040
Volume boundary metering strategy	While this reduces total capex by $14m, we would like further assurance that the reduction in choice for residents in all sized apartment complexes will result in lower overall cost
Transformation program	Please provide further clarification on the savings in labour costs to be assumed in the base year opex
Productivity improvements	Consistent with regulatory practice
Accept AER rate of return and tax positions	Consistent with regulatory practice
CESS	We would like to continue to be engaged in the development of this initiative

MOVE TO A NET-ZERO CARBON FUTURE AND STRANDED ASSET RISK

- JGN has proposed 3 strategic solutions to manage this risk – (1) shortening of asset lives for future capex, (2) reducing RAB growth & (3) expensing certain costs that used to be capitalised
- We would like JGN to make out a clearer case that the likelihood of stranded asset risk has increased over the last 5 years:

Factors that make the risk more likely	Factors that suggest the risk may be manageable
• Average usage rate for natural gas consumption is declining	• New connections growth continuing at similar pace to 2015-20
• Customer sentiment survey suggests more customers aren't prepared to pay any more for hydrogen	• Hydrogen may displace natural gas in networks
• Wholesale gas price rises make gas less competitive (compared with electricity)	• Disconnection rates haven't declined
	• Hydrogen is being successfully trialled in other jurisdictions (eg UK and Japan)

MOVE TO A NET-ZERO CARBON FUTURE AND STRANDED ASSET RISK

- Even if there is an increased risk of asset stranding today compared to 5 years ago , it is not clear that changing asset lives for depreciation purposes is the best option for customers – could JGN consider further alternatives that will maintain cost pressures and ensure gas remains as competitive as possible – eg moving from straight line depreciation to economic depreciation
- Even if accelerated depreciation is one of the best options to manage the risk, can JGN provide a clearer case to show that the proposed changes to asset lives should be made in the Draft Plan to help manage the risks as opposed to waiting another 5 years to allow time for Hydrogen to be proven as an economically viable substitute for natural gas in the network?
- Can JGN show that JGN is sharing some of the risk of stranded assets rather than it just being about the allocation of the risk between current and future customers

INTERGENERATIONAL EQUITY ISSUES

- A number of proposals in the Draft Plan are seeking to change the balance between tariff levels payable by current customers vs those payable by future customers:

Proposal in DP	Impact on 2020-25 revenues	ECA Position
Expensing of all corporate overheads that used to be capitalised	⇧	Can JGN outline the case for why this is in long term interests of consumers
Shortening asset lives for new capex (accelerating depreciation)	⇧	Can JGN outline the case for why this is in the long term interests of consumers
Adopt a medium term approach to certain capex items so as to reduce capex levels	⇩	In long term interests of consumers
Accelerate depreciation of pigging assets	$-	Does not appear to cost/benefit consumers one way or the other

COMMENTS ON SPECIFIC BUILDING BLOCKS

ROLL FORWARD OF RAB

- While total actual capex between 2015-20 is in line with the AER approved total, there are significant divergences in the line item allowances. Can JGN give further reasons for the divergences:
  - Helps understand appropriateness of what was spent
  - Gives greater confidence in the prudency and efficiency of the forecast capex in DP

Capex Category	Actual Expenditure ($m)	Variance from AER approved forecast (%)
Connections	585.18	⇧47%
Meter Replacement	108.45	⇩44%
Facilities & Pipes	68.95	⇩45%
Information Technology	107.77	⇩27%
Augmentation	51.03	⇩54%
Mains replacement	31.91	⇩58%
Other	60.64	⇧34%

FORECAST CAPEX

- Affordability for consumers is best served (in the long term) by managing capex levels so as to keep the level of the RAB at manageable levels, particularly if network utilisation declines. ECA would like further clarity that a medium term approach to certain capex investment maintains RAB level and ensures that there is negligible impact on average network bills if utilisation increases
- While JGN compares favourably against industry peers on most capex categories, we would like further clarification on reasons for why it doesn't compare as well on connection capex:
  - A new methodology for forecasting has been proposed
  - this capex category represents 45% of total forecast capex; and
  - unit costs are increasing (particularly for EtG connections)
- Proposed approach to mains replacement capex – staggered investment to replace mains only where the costs and risks from continuing to use the pipe clearly exceed the replacement costs – appears to be in long term consumer interests.

OPERATING EXPENDITURE

- Proposed methodology for setting the forecast opex for 2020-25 is largely consistent with the AER's methodology adopted in current plan

Step	Consistent with AER methodology	Other Comment
Establish an efficient base year	👍	Propose to use actuals for reg year 2019 but remove one off transformation costs and UAFG. Expected adjusted actuals will align with AER approved allowance for that year.
Adjust for change in accounting treatment	☜	Corporate overheads which were previously capitalised are now proposed to be expensed. While this removes the need to include a return component, it will lead to increased charges until the mid 2030s at a time when affordability of gas will be most critical
Trending base year forward	👍	Rate of change approach is consistent with regulatory precedent
Developing specific forecasts	👍	UAG allowance methodology is consistent with approved AER methodology
Forecast of step change items	👍	No step changes being proposed in DP Could JGN more clearly show how ongoing savings in labour costs created by the transformation program are being factored in the opex forecast

OPERATING EXPENDITURE

- JGN's forecast opex compares favourably on a number of benchmarks:

Benchmark	2015-20	As per Draft Plan	Comment
Opex per dwelling	$139	$119	
Opex Partial Factor Productivity	2nd	2nd	Ranked 2nd out of gas distribution service providers
Opex per customer	N/A	Mid-tier	Penetration rates need to be taken into a/c

- Productivity target of 0.5% - we would like further justification that this level is still appropriate and consistent with regulatory precedent.
- ECA would like further details on the Cost Allocation Methodology changes that are proposed for both JEN and JGN other than the proposal to expense corporate overheads that have previously been capitalised.

OTHER MATTERS

SERVICES

- **Unbundling of the reconnection service from the disconnection service** – unless AER's reasoning from the 2015 determination for retaining this service as an ancillary service has changed, ECA would like to see what benefit arises to consumers by unbundling this service
- **Wasted visit charge** – Could JGN more clearly outline a case for the inclusion of this charge, including whether there is to be a corresponding decrease in other ancillary charges
- **Separation of the meter data service from the reference service** – if gas metering contestability is allowed, this should be separated

OTHER MATTERS FOR JGN TO CONSIDER

- Could JGN consider what scope there is to modify (including assessment of potential consumer impacts) the tariff/charging arrangements for residential and small commercial customers to incentivise greater and continued usage of the network – eg:
  - Tiered tariff arrangements
  - Rebate schemes on appliances
- Could JGN consider a separate reference tariff or surcharge to cover augmentation for Sydney new airport precinct, particularly if most gas usage will be by larger commercial and industrial in that precinct
- If gas is able to be a competitive alternative to electricity, consideration should be given to further research & development in such areas as:
  - gas solutions for decentralised electricity generation opportunities
  - smart metering. Customer will then have access to information to enable informed choices to be made. Government subsidies could be considered to run a trial program