

Mr Dale Johanssen
Australian Energy Regulator
GPO Box 3131
Canberra, ACT, 2601

Submitted online:

15 June 2023

Dear Mr Johanssen,

Issues paper - Review of gas distribution network reference tariff variation mechanism and declining block tariffs

The Australian Energy Council (AEC) welcomes the opportunity to respond to the Issues paper - Review of gas distribution network reference tariff variation mechanism and declining block tariffs.

The Australian Energy Council (AEC) is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. Our members collectively generate the overwhelming majority of electricity in Australia, sell gas and electricity to millions of homes and businesses, and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 percent emissions reduction target by 2035 and is part of the Australian Climate Roundtable promoting climate ambition.

The problem statement - protecting consumers in transitioning markets.

As governments implement policies to hasten the transition to renewable energy sources, they are for all practical purposes transitioning consumption from natural gas to electricity. Therefore, this is the overarching consideration when reviewing the alignment of current regulatory approaches with jurisdictional policies.

The regulator acts as the arbiter of the bargain between current and future gas consumers. This is because consumers that remain connected to gas networks as demand falls are logically exposed to price increases as the cost burden shifts from consumers that are no longer connected to the regulated network to the smaller number of consumers that continue to be so. In theory these higher prices that are charged to consumers who remain connected to the gas network may result in price increases resulting from falling demand accelerating those leaving the gas network, perpetuating further reductions in demand, and ultimately resulting in asset stranding.

For consumers, transitioning their energy consumption from gas to electricity is not a “no regrets” decision in practice for the greater number of either residential or commercial and industrial (C&I) users. Many will face significant costs to exit gas for electricity from their appliance mix, their usage standpoints and their consumption profiles. The AEC acknowledges that adding costs to business and households as a function of energy policy is sometimes inevitable and may well prove so again with the addition of an environmental objective to the NGO. However, to the extent possible consumers should be protected from a costly transition.

The AEC does not consider that extreme changes in demand that creates the potential for stranding risk is either likely or, if it were likely, unmanageable in the next regulatory period. How the transition is managed will be the key to mitigating consumer impact and stranding risk and a prudent AER should take actions to minimise the expected cost of any future stranding due to climate policy.

The AEC agrees broadly with the AER that an acceleration in the rate of depreciation is an appropriate method to meet the likelihood and expected costs of any such stranding. Modelling from the most recent Victorian GAAR showed that accelerated depreciation and progressive customer switching won't cause big changes in prices.

The AEC does not believe that any change to tariff structures will be particularly effective in mitigating stranding risk or achieving environmental objectives. Whilst we discuss possible tariff changes in this submission we are not advocating that it should be done; rather that if any change is to be made that it be done in a principled way to avoid shock to consumers and facilitate an orderly transition from gas. Coupled with accelerated depreciation, such an approach could help mitigate volume and stranding risk in the next and subsequent regulatory periods.

Stranding Risk and the method of regulation

The AEC acknowledge that gas policy uncertainty creates increased difficulty in volume forecasting under the price cap. But it is neither wise nor in the interests of consumers during an uncertain period for gas policies, to move to a method of regulation that would just transfer the volume risk to customers. The AEC does not consider that extreme changes in demand that creates the potential for stranding risk is likely for the foreseeable future. Therefore, we do not see compelling reasons for any move from a weighted average price cap (the price cap) to a revenue cap now.

Volume risk is a function of uncertain gas demand, and uncertain gas demand will result broadly in both increases in price and with volatility in price. We acknowledge that certainty in gas demand is important under a price cap, and we know that any under forecasting under the price cap makes average tariffs higher. There is an incentive in the price cap to sell more gas; to increase asset utilisation rates and thereby lower costs to all customers. This is now perhaps inconsistent with government/s gas policies and perhaps also with the environmental objective in the NGO. Under the price cap there is also generally an incentive to price efficiently when demand is stable, but history provides a disappointing guide as to how this has benefitted gas distributors against consumers in the past when actual volumes have turned out to be higher than forecast. But what is being reviewed here of course is not whether customers have been well served by the historical regime, but whether any change to a revenue cap might be an effective regulatory tool to mitigate stranding risk.

Neither the price cap nor revenue cap were designed to address degasification, or to achieve any "alignment" between these regulatory controls and the (unfortunately) largely fluid multiple federal and state environment policies. If at all plausible, such alignment with states will be a "least worst fit", and will still not be a solution or even mitigation to asset stranding. Whilst not explicit in the review, gas distribution networks could be justified in having little confidence in the stability of state gas policies, and these exogenous risks would clearly make a shift to a revenue cap attractive to them. And given jurisdictional divergence it's questionable at what point in time such alignment could be either necessary or useful beyond consideration of the state's various published horizons for phase out of natural gas (which may trigger review). In light of these issues the NGO should continue to provide the necessary guidance to the AER.

Finally, any change from a price to a revenue cap that then shifts the volume risk from the regulated businesses, who we acknowledge are under pressure from gas policy approaches to end users who are also under the same if not greater pressure from the same policies does not make sense. Our view therefore is that the acceleration in the rate of depreciation is the appropriate method to meet the likelihood and expected costs of stranding, and a change to the form of regulation is not at present warranted.

Stranding risk and moving away from and declining block tariffs

Whilst we discuss the possibility of moving away from declining block tariffs, we are not advocating that it should be done; under the status quo increases in gas prices have caused sufficient harm and increasing them further should not be considered in isolation. Rather we are presenting a view that if change must be made that it be done in a way to avoid shock to consumers and an orderly transition from gas. In previous submissions to electricity network tariff reform the AEC has

advocated reflecting fixed costs more adequately in fixed charges, exploring locational pricing where justified, and minimizing price shock to customers. Applying these principles, then an orderly transition to reducing both the number of new gas connections and existing connections whilst maintaining a slow decline in gas consumption as replacement with electricity happens may be achievable.

As the AER notes, historically declining block tariffs reflected in part that large customers helped promote economies of scale for a network. Encouraging consumption via a price cap incentive and declining block tariffs that both theoretically improves asset utilisation has also encouraged small customers to install gas appliances. Fairness to consumers when reversing this approach is essential.

Retailers have learned that transitioning consumers to pricing structures designed to encourage a shift in behaviour or time of use or appliance mix generally fails. As the ECA noted in its 2022 summary of retailer attitudes to cost reflective pricing, a large proportion of consumers don't like such structures, and they generate many complaints. Retailers also reported to the ECA that energy literacy was relatively low, particularly for vulnerable consumers, and that many consumers do not understand how such pricing structures work and how their behaviour determines how much their final bill is. The AEC is concerned that in the case of reversing out tariff structures that the hypothesis that this will move customers off gas may turn out to be largely theoretical, leaving many larger consumers and higher end residential users with high barriers to exit gas for electricity simply worse off.

Moving to flat or inclining tariffs would also likely increase bills for large I & C users and might in turn encourage some of them to leave the gas network. Whilst this is not an industry support forum, these large users may also face significant exit costs from gas. It should not be an unintended consequence of the NGO environmental objective to close a business because it cannot meet the hurdle of either its increasing gas costs or its fuel conversion costs in the current economic climate.

Locational and perhaps even zonal considerations are important in tariff reform considerations. Small (residential) customers in Queensland for example have different needs and usage that those in Victoria for example. And taking the Victorian example, a switch from gas central heating and hot water to all electric is a significant renovation that will likely involve wiring and other costly works in addition to the appliance replacement costs. These costs generally and rationally compel both homeowners and landlords to retain their existing gas appliance suites, and to only consider conversion at the end of appliance life. Interim tariff structures should avoid the consequence of simply locking them in to paying more for their gas. This may lead to differing and unequal approaches to jurisdictional gas markets; albeit driven by a single environmental objective.

Tariff change

To reduce bill shock for customers an interim approach to restructuring gas tariffs, addressing variances in block tariffs with a longer term target of eventually getting to flat tariffs *if that is justified* in meeting the NGO. Where justified, this change could be accompanied by a method to gradually increase the fixed charges component of network tariffs, as a reflection of the fixed cost component, with these higher fixed costs being balanced out of consumption charges.

Increasing the fixed cost component and the progressive flattening of the declining block structure may:

- Encourage a reduction in the number of gas connections if that is an environmental objective. An approach that encourages those with the lowest barriers to exiting gas to go first, and also discourages new gas connections which may hasten electrification. There is a direct correlation between gas usage and gas dependency for residential or business processes. Higher fixed costs could discourage residential "cooktop only" connections for example.

- Assist gas volume stability in the next period. The AEC acknowledges that whilst a significant number of connections may be affected the effect on overall gas volumes should be small. But the overarching contribution to the environmental objective is still relevant in that those existing connections abolished, or new connections avoided will not expand their portfolio of gas appliances, thus encouraging electrification.
- Avoid bill shock and hardship. The interim approach should seek to limit impacts on users who are not able to readily substitute gas from either a business process or residential appliance perspective. In the residential cohort this is particularly true for those with gas heating and gas hot water, many of whom are located in the colder climate of Victoria. In a time when businesses and consumers are increasingly struggling with higher energy costs, general cost of living constraints, and increasing interest rates the their inability to fund or service the costs of high capital changeover appliances will trap them with forced choices of higher than necessary energy bills, or going cold, or reducing production.
- Encourage efficient pricing. There is an argument to make seasonal pricing more granular, and to review the extent of different locational tariffs. In any case, not all retailers would pass through changes in network tariff structures in their retail tariff structures, but nonetheless the network costs will be broadly reflected in them. Network costs are primarily fixed, and small volume residential consumers also have the same fixed retail cost to serve as larger volume ones for example. Competitive pressure means it would be unlikely that retailers would smear further increases in fixed charges as opposed to applying them to the customers incurring them.

Please contact the undersigned at [REDACTED] should you wish to discuss.

Yours sincerely,

David Markham
Australian Energy Council