ECA RESPONSE TO JEMENA GAS NETWORKS' (JGN) 2020-25 ACCESS ARRANGEMENT PROPOSAL

TRAC Partners

EXECUTIVE SUMMARY

OVERARCHING OBJECTIVE THAT SHOULD FRAME JGN’S 2020 PLAN

- JGN has earnestly attempted to understand the interests of consumers in developing the 2020 Plan.
- Keeping gas prices as low as possible for today’s household and small business consumers should be the overarching objective that should frame one’s assessment of all aspects of JGN’s 2020 Plan.
- This will:
  - help keep gas as competitive as possible, particularly for NSW where gas is a fuel of choice;
  - maximise the incentive for consumers to continue usage of the network for the foreseeable future, particularly if consumption rates are at risk of reducing; and
  - align very closely with the interests of investors. A proposal that best incentivises continued use of the asset gives the business the best chance that it will be able to recover its investment and earn a return on that investment.
- This is in the long term interest of today’s and tomorrow’s consumers and investors in infrastructure.
- Our assessment of JGN’s 2020 Plan has therefore been undertaken within this lens.

KEY FEATURES OF 2020 PLAN THAT ALIGN WITH ECA'S OBJECTIVE

There are a number of high level features of JGN's 2020 Plan that align with ECA's objective:

2020 Plan Feature	Relevant ECA Objective
• Network component of average residential and commercial retail bills will reduce by 11% over the 2020-25 period (18% including handback of over-recoveries during 2015-20)	Long term consumer interest with respect to price
• Smoothing of network bill for average coastal customer within the 10% side constraint	Long term consumer interest with respect to price
• Sharing of price reductions across all customer classes	Long term consumer interest with respect to price
• No compromise on prior service levels	Long term consumer interest with respect to reliability and security of supply
• Medium term approach to certain capex so as to reduce Regulatory Asset Base (RAB) growth	Long term consumer interest with respect to price
• Operating expenditure efficiencies	Long term consumer interest with respect to price and reliability and security of supply

However, there are areas for improvement or aspects which we believe requires further investigation by the AER, particularly in relation to the 2020 strategic initiatives……….

The following slides comment on each of the 2020 Initiatives:

- - consistent with key objective
- - further work or analysis required before ECA could accept that it is consistent

JGN'S 2020 INITIATIVES

Focus Area	JGN Strategic Initiative	Our Position
Capital expenditure	Shorter planning horizon to reduce capital expenditure, where appropriate	(slide 11)
	Reduce capital expenditure through volume boundary metering strategy	(slides 12 & 31)
	Continue to connect new customers to spread our costs over larger customer base	
Operating expenditure	Expense corporate overheads and pigging costs previously capitalised	(slide 20)
	Deliver transformation program and ongoing productivity improvements	(slides 12, 19 & 21)
Rate of return and Tax	Accept AER's approach in guidelines	
Tax	Retain current approach which results in a lower tax burden on customers than other approaches	

TRAC Partners

JGN'S 2020 INITIATIVES

Focus Area	JGN Strategic Initiative	ECA Comments
Innovation	Invest in hydrogen (the Western Sydney Green Gas Trial) and only apply for cost-recovery if successful (speculative capital expenditure)	👍
	Limit innovation investment to industry programs, otherwise self-fund additional innovation. JGN will not propose additional funding for JGN - specific innovation.	👍
Depreciation	Shorten asset lives for some new investment to ensure fair recovery of costs from customers	☜ (slides 13, 14, 23 & 24)
	Accelerate depreciation of in line inspections	👍
Pricing and service levels	Providing common minimum levels of service to all customers across NSW	👍
	Retain current approach to country/city pricing, so only customers benefiting from the Sydney trunk pay for it	👍
Incentive Mechanisms	Introduce a CESS	☜ (slides 26 & 27)

JGN'S CONSUMER ENGAGEMENT

TRAC Partners

HOW THE JGN CONSUMER ENGAGEMENT PROCESS COMPARES

Comparator	JGN 2020-25 Proposal	Vic Electricity DBs (other than JEN)[1]	AGN (Vic)[2]	ATCO Gas[3]
# of focus group sessions & forums	43	3 - 10	14	12
Consumers/customers engaged in sessions[4]	333 (0.023%)	76 – 174 (0.025%)	120 (0.018%)	94 (0.013%)
Surveys completed	293	1609 - 1950	N/A	18
JGN Attendees at sessions	Executive & Board	Executive	Executive	Executive
Deep Dive sessions	1	3	4	N/A

Notes
1 – for the 2021-25 revenue period. Figures are derived from the summary by Spencer & Co for ECA
2 – for the AGN (Vic) 2018-22 AA Proposal. Figures are derived from AGN's Customer Overview
3 – for the ATCO 2020-24 AA Proposal. Figures are derived from ATCO's Voice of Customer program Insights report
4 – The percentage figures in brackets represent the percentage of total customers in each network who were engaged in the sessions.
N/A – figures are not publicly available

TRAC Partners

COMMENTS ON JGN'S STRATEGIC INITIATIVES

JGN'S STRATEGIC INITIATIVES

- JGN's 2020 Plan has been developed with the aim of addressing 3 key strategic imperatives:
  - Improving the cost competitiveness of gas by 2025
  - The impact of a possible move to a zero carbon network by 2050
  - The perceived need to balance consumer outcomes, now and into the future (intergenerational equity)
- JGN has implemented a number of initiatives in its 2020 Plan that it claims are aimed at addressing these imperatives (**2020 Initiatives**).
- Overall, ECA supports the key outcomes from 2020 Plan to address the cost competitiveness imperative, being:
  - Delivering a 11% saving in the network component of the average residential and small business gas bill over the 5 year period. This would appear to be in consumers' interests
  - When coupled with the return of revenue JGN received in the current period, the network component of total charges will reduce 18% over the 5 year period for all classes of consumer
- However, we believe that improving cost competitiveness should be the overarching imperative that frames all aspects of the 2020 Plan

2020 INITIATIVES TO IMPROVE COST COMPETITIVENESS

Comments on the 2020 Initiatives proposed to deliver savings and improve JGN's cost competitiveness:

Cost Competitiveness Initiative	Our Comment
A mixed approach for augmentation capex (ie a combination of long and medium term solutions for different augmentations across the network)	We support the mixed approach for augmentations as this delivers the best cost competitiveness and affordability outcomes in the short to medium term However, for the Sydney Metropolis augmentation, we would like further consideration of a separate tariff structure for consumers in the new precinct.
Sydney primary main integrity management project	We support JGN's proposal to build two new secondary mains as it is safer, delivers short term affordability and is the lowest overall cost
Adopt a medium term approach for mains replacement	We support JGN's approach for mains replacement as this delivers the best affordability outcomes
Shorter planning horizon to reduce capital expenditure, where appropriate. 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 pa) over the next 40 years • If network is in decline – it saves customers about $12 pa over the next 40 years

Partners

2020 INITIATIVES TO IMPROVE COST COMPETITIVENESS

Cost Competitiveness Initiative	ECA Comment
Volume boundary metering strategy	While this reduces total capex by $14m, we believe that a further assessment should be undertaken to assess: - Whether the capex savings will be less than the costs to be passed on by embedded network operators - What impact the reduction in choice for residents in all sized apartment complexes will have on the overall cost of gas. See slides 12 & 31
Transformation program	It is still not clear how transformation program savings have been taken into account in the setting of the base year opex (see slides 19 & 21).
Productivity improvements	We support the proposed productivity rate of 0.74
Accept AER rate of return and tax positions	We support the approaches as they are consistent with regulatory practice
CESS	See slides 26 & 27 for our comments on the CESS

TRAC Partners

2020 INITIATIVES TO ADDRESS IMPACT OF MOVE TO A NET-ZERO CARBON FUTURE

- 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
- While Attachment 7.10 of JGN's 2020 Plan contains more information to support JGN's approach to shorten asset lives, we are still to be convinced 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 (projected increase the size of Canberra and new Sydney airport precinct)
• Customer sentiment survey suggests more customers aren't prepared to pay any more for hydrogen	• Hydrogen may displace natural gas in networks.. Hydrogen is being successfully trialled in other jurisdictions (eg UK and Japan)
• Wholesale gas price rises make gas less competitive (compared with electricity)	• Disconnection rates haven't declined • LNG import terminal at Port Kembla is imminent
	• Government policy – net-zero carbon aspiration is only in draft. Hydrogen Strategy to be completed by YE 2019

2020 INITIATIVES TO ADDRESS IMPACT OF MOVE TO A NET-ZERO CARBON FUTURE

- Even if there is an increased risk of asset stranding, given the overarching objective in the setting of the 2020 Plan, retaining the current asset lives for future investments will result in the average consumer's annual network charges being $3 a year cheaper than compared with JGN's proposal.
- In NSW, gas is a fuel of choice and so, ensuring gas is as affordable as possible today maximises the incentives for continued asset utilisation . This maximises the likelihood of continued use of the network and minimises the risk that the asset may become stranded in the future.
- Furthermore, keeping prices as low as possible during the 2020 Plan period and waiting to re-assess the position on asset lives until the next re-set of 2026 will have other benefits:
    - It will give time to provide further clarity around the Hydrogen Strategy which is due to be reported to the COAG Energy Council at the end of this year – if hydrogen can be commercialised and has a role to play in the NSW network, any risk of asset stranding diminishes significantly and so there should be no need to make a change to asset lives at that point in time;
    - It also allows time to demonstrate how the market will respond to supply from the LNG import terminal at Port Kembla which is scheduled to be operational in 2020.
- Even if there is a view that asset lives should be shortened from 2026 onwards, JGN's own analysis shows that customers will only pay $10 more per annum from 2051 onwards.

INTERGENERATIONAL EQUITY ISSUES

A number of proposals in the 2020 Plan are seeking to change the balance between tariff levels payable by current customers vs those payable by future customers. Our comments are as follows:

Proposal in 2020 Plan	Impact on 2020-25 Revenue	Our Comments
Expensing of all corporate overheads that used to be capitalised	⇧	See slide 20
Shortening asset lives for new capex (accelerating depreciation)	⇧	See slides 13, 14, 23 & 24
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

TRAC Partners

COMMENTS ON SPECIFIC BUILDING BLOCKS

TRAC Partners

ROLL FORWARD OF RAB

- While total actual/estimated capex between 2015-20 is slightly below the AER approved total (by 6%), there are significant divergences in most line items.

Capex Category	Actual 15-20 Expenditure ($m)	Variance from AER approved forecast (%)
Connections	480.9	⇧43%
Meter Replacement	85.1	⇩49%
Facilities & Pipes	63.8	⇩40%
Information Technology	119.5	⇩19%
Augmentation	40.0	⇩58%
Mains replacement	27.3	⇩58%
Other	45.5	⇧2%

- Furthermore, JGN's forecast of capex for the 2020 Plan has varied significantly from that in the Draft Plan to that in the 2020 Plan (on a line item basis)
- These divergences raise 2 issues the AER should consider in more detail:
  - whether all items of actual capex for 15-20 should be rolled into the RAB
  - How reliable are past capex levels as a guide for assessing the prudency and efficiency of JGN's forecast capex in the 2020 Plan?

TRAC Partners

OTHER FORECAST CAPEX ISSUES

Forecast Capex Issue Raised by ECA in response to Draft Plan	How JGN responded in 2020 Plan	Our Further Comment
Further explanation required to ensure that saving expenditure in one period on preventative maintenance does not lead to greater expenditure being incurred in subsequent periods on reactive maintenance	☜	There does not appear to be adequate information in the 2020 Plan to form a view on this issue and we encourage the AER to investigate further.
Connections Capex – further clarification on the prudency and efficiency of the forecast connection capital expenditure	☜	We have not been able to review JGN's connections and metering forecasting methodology document and request that this be reviewed by the AER given connections capex represents a significant portion of forecast capex in the 2020 Plan.
Outline the extent to which the replacement capex it proposes to incur will align with the AER's industry practice application note for asset replacement planning	☜	Given the JGN forecast for asset replacement was not developed with a focus on complying with the AER's guideline but rather having regard to JGN's ISO 55001 certified asset management system, the AER should assess the extent to which that system leads to forecasts for asset replacement that are consistent with the NGO.

OPERATING EXPENDITURE ISSUES

- While we recognise that JGN has benchmarked well on its opex efficiency (as per Attachment 6.4) and that the proposed methodology for setting the forecast opex for 2020-25 is largely consistent with the AER's methodology adopted in current plan, we have some comments:

Step	How JGN responded in 2020 Plan	Our Further Comments
Establish an efficient base year	☜	While JGN proposes to use actuals for reg year 2019 (once they are audited) but remove one off transformation costs and UAFG to create the base year, it is not clear how transformation program savings have been taken into account (see slides 12 & 21).
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 (see slide 20).
Trending base year forward	👍	Rate of change approach is consistent with regulatory precedent
Developing specific forecasts	☜	While UAG allowance methodology is consistent with approved AER methodology, the AER should explore why UAG volumes are higher at a time when consumption has reduced.
Forecast of step change items	👍	No step changes being proposed.

FORECAST OPEX – EXPENSING ALL CORPORATE OVERHEADS

- In response to the Draft Plan, ECA requested that JGN provide further justification for changing its accounting treatment for all corporate overhead expenditure - which would see 40% of corporate overheads expensed as opposed to the current approach of capitalising them
- JGN's 2020 Plan still proposes to expend all corporate overheads for the following reasons (see attachment 6.1):
  - Consistency with accounting practice
  - Aligns with methodology endorsed by AER for JEN in Victoria
  - While it increases opex by $75.8m during 2021-25, it reduces capex levels by the same amount
- We are not yet convinced that this proposed change is in the interests of consumers because:
  - it is important to keep network costs as low as possible in the short to medium term so as to incentivise gas consumption levels;
  - we are not convinced that capex levels will reduce by a corresponding amount during 2020-25. In fact, expensing all overheads will lead to higher tariffs for 2020-25; and
  - it will lead to increased charges until the mid 2030s, the period when ensuring affordability of gas is most critical.

TRAC Partners

FORECAST OPEX – TRANSFORMATION PROGRAM

- In response to the Draft Plan, ECA requested that JGN provide further clarification on the savings in costs assumed in the base year as a result of the implementation of the transformation program.
- JGN's 2020 Plan proposes that a total of $39m in opex reductions will be achieved over the 20-25 period ($8m pa) as a result of the program but this has required an outlay of $13m in 2018/19 (see Attachment 6.1).
- We would have expected to have seen a similar annual saving in the total opex for 2018/19 but it is not apparent from the information provided in Attachment 6.1 – estimated actuals for 18/19 operating and maintenance expenditure are slightly above AER allowance (Table 3-1 in Att6.1).
- We would like the AER to satisfy itself that the transformation savings have been included in the base year and identify the areas of operating expenditure where the savings are being achieved.

TRAC Partners

OTHER OPERATING EXPENDITURE ISSUES

- While JGN's opex compares favourably on a number of benchmarks (as per Attachment 6.4), we note that the opex per dwelling rate is increasing (see Figure OV-1 in Attachment 6.1). It is not apparent why, based on the information submitted by JGN. We would like the AER to explore the reasoning for this given there is a significant increase in new connections being proposed in the 2020 Plan
- We believe further details need to be provided to explain 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; and
  - The removal of non reference service related opex from the base year opex

TRAC Partners

DEPRECIATION & ASSET LIVES

- JGN proposes to change the standard asset lives for new investments in all asset classes as follows. This change will increase JGN's revenue in the 2020 Plan by $22m (compared to retaining the current standard lives):

Asset Class	Current standard lives (years)	Proposed standard lives for new investment (years)	Percentage of capital expenditure in asset class compared to capital program as a whole
Trunks	80	50	0%
High pressure mains	80	50	13%
Meters/meter reading devices	20	15	21%
Medium pressure mains	50	30	15%
Medium pressure services	50	30	32%

- Retaining current asset lives for 2020-25 would reduce the network bill for customers in the 2020-25 period by $3 pa per customer

TRAC Partners

DEPRECIATION & ASSET LIVES

- Attachment 7.10 contains JGN's justification for this proposed change:
  - Gas now has an uncertain future because:
    - The policy push to decarbonisation
    - The gas value proposition for consumers is diminishing
    - Uncertainty about whether hydrogen is a viable alternative to or complement for natural gas
  - The NGR and NGL allow for it – citing recent decisions by the AER
  - A cost/benefit analysis
- We do not believe this approach delivers on what we believe should be the primary objective of keeping gas prices as affordable as possible
- We have not seen the detailed calculations or the assumptions used in the cost/benefit analysis to test the veracity of the analysis and would encourage the AER to undertake this work before the Draft Decision
- JGN claims that this change does not reallocate risk from JGN to its customers. We would like the AER to test this as JGN's proposal would appear to be reallocating risk.
- The NGL and NGR do not guarantee the service provider recovery of capital, rather they give the opportunity to recover the investment and a return on it

RESPONSE TO INCENTIVE SCHEMES

TRAC Partners

CESS – THE CASE HAS NOT BEEN MADE

- We are not yet convinced that a case has been made for the introduction of a CESS because:
  - Gas is a fuel of choice in NSW and there should already appear to be adequate incentives for JGN to deliver efficient capex levels
  - A CESS type mechanism has not been universally adopted across gas network businesses in Australia
- JGN's track record on non-connections capex has significantly underspent on capex allowances set by the AER – in some instances by as much as 58% (see slide 17). It would be more appropriate for the AER to initially focus on ensuring JGN's capex forecasting is more accurate and efficient before implementing a CESS style scheme.
- If a similar magnitude of savings as were achieved in 2015-20 are replicated in 2020-25, the competitiveness of gas would be impacted on 2 fronts:
  - During 2020-25, tariffs will be increased because of higher forecast capex
  - Consumers would be required to share savings in the future 5 year period

CESS

- We believe the AER should undertake a cost/benefit analysis which compares the position for consumers with the CESS mechanism included against the position without the CESS mechanism. This is important because:
  - as gas is a fuel of choice in NSW, there would already appear to be adequate incentives for JGN to deliver efficient capex levels
  - the risk that introducing a significant change has the potential to impact consumers in a big way if the CESS is not properly designed.
- To the extent that the analysis indicates a CESS mechanism is warranted:
  - The AER should explore how the Vic DB's CESS mechanisms have performed; and
  - We support a design which excludes connections capex from the methodology

TRAC Partners

HOW HAS JGN RESPONDED TO OTHER ISSUES IN THE DRAFT PLAN RAISED BY ECA?

TRAC Partners

JGN'S RESPONSE TO ISSUES RAISED BY ECA IN DRAFT PLAN

- In February, we raised issues on a number of matters in the JGN Draft Plan. We have outlined below our current thoughts on how JGN has responded to each matter in the 2020 Plan:

Draft Plan issue raised by ECA	How has JGN responded in 2020 Plan
Tariff structuring	- further cost benefit analysis required (see slide 32)
Volume boundary metering	- further cost benefit analysis required (see slide 31)
Opex efficiencies / productivity target	- JGN now proposes a 0.74% productivity target
Service levels	
Rebate schemes	- not proposing to refine its appliance rebate scheme (see slide 33)
Expensing corporate overheads	- case for changing accounting treatment hasn't been adequately made (see slide 20)

JGN'S RESPONSE TO ISSUES RAISED BY ECA IN DRAFT PLAN

Draft Plan issue raised by ECA	ECA's position on how has JGN responded in 2020 Plan
Unbundling the disconnection and reconnection charge	- we agree that no case has yet been made to unbundle the charge. We also endorse the proposal to offer am/pm appointments for reconnections
Wasted visit charge	- we would like JGN to provide more detail on whether(and to what extent) there is to be a corresponding decrease in other ancillary charges now that this is a new stand alone wasted visit charge
Separate reference tariff or surcharge for the new Sydney airport precinct	- a further cost benefit analysis is required (see slide 32)
Query whether Sydney CPI is more appropriate to use in tariff variation mechanism	- Regulatory precedent is not, of itself, a justification. But even if it is, not all regulatory decisions use the All 8 Cities CPI. JGN should be asked to demonstrate that most of its operating costs are not "Sydney centric".
10% side constraint to assist in smoothing retail gas bill	- we support the continuation of the 10% side constraint

JGN'S RESPONSE TO ECA'S COMMENTS ON VOLUME BOUNDARY METERING ISSUES

- JGN claims that the case for requiring boundary-only metering for new apartment buildings is demonstrated by:
  - saving around $6m in capex pa, therefore benefitting all consumers; and
  - Keeping gas competitive in the high rise embedded network market.
- However, this analysis does not include an assessment of what additional costs will be incurred by consumers in having to deal with an additional supplier in the value chain – ie the embedded network operator.
- Furthermore, residents of high rise apartments no longer have the ability to choose between JGN supplying gas and hot water meters to their apartments or an embedded network service provider.
- We believe that a further cost benefit analysis should be undertaken, which includes an analysis of these matters.

JGN'S RESPONSE TO ECA'S COMMENTS ON TARIFF STRUCTURE ISSUES

- JGN has not adopted ECA's suggestion from the Draft Plan that changes be made to JGN's current tariff tiering arrangements so as to incentivise greater and continued use of the network primarily because:
  - simplicity is strongly desired by residential customers to understand their bills; and
  - retailers require simplicity to reduce transaction costs – currently some retailers do not offer all of the tariff tiers currently offered by JGN
- We encourage the AER to test with retailers and JGN the cost/benefit of a change in tariff blocks/tiers:
  - what additional costs would be incurred by retailers
  - the extent of benefits to additional use of network
  - How to incentivise retailers to reflect distribution tiers in retail bills

TRAC Partners

JGN'S RESPONSE TO REBATE SCHEME IMPROVEMENTS

- JGN has not adopted ECA's suggestion from the Draft Plan that it should look to further refinements to its appliance rebate scheme so as to incentivise greater and continued use of the network (Attachment 6.1).
- We have not seen evidence in the 2020 Plan to demonstrate whether or not JGN had considered refinements.
- While we agree with JGN that a rebate scheme should be structured to ensure gas appliances can be competitive (from both an installation and running cost perspective) with competing electrical appliances, we think that further consideration should be given to refining the scheme such as:
  - whether it should be extended to all appliances purchased (rather than only where one is purchased and a new gas point is fitted); and
  - how it can be designed to encourage take up of energy efficient appliances.

TRAC Partners

JGN'S RESPONSE TO SEPARATE REFERENCE TARIFF FOR SYDNEY AIRPORT PRECINCT

- While JGN has acted on ECA's suggestion from the Draft Plan that it should consider implementing a separate reference tariff or surcharge to cover augmentation for the new Sydney airport precinct, JGN has decided not to implement a separate tariff or surcharge for small to medium commercial customers.
- JGN's reasons are:
  - its initial estimates do not show a revenue shortfall compared to the costs to augment the network to the area. This means existing customers would actually benefit from sharing JGN's fixed costs amongst the many potential new customers in this region.
  - An additional tariff would not improve the objective for simpler pricing for consumers and retailers
- The AER should be shown the estimations undertaken by JGN. We would assume this is in the form of a cost benefit analysis.

TRAC Partners