30 September 2022

Arek Gulbenkoglu
General Manager Network Expenditure
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Email: VICGAAR2023@aer.gov.au

Dear Mr Gulbenkoglu,

RE: Submission to Victorian gas access arrangement proposals

Origin Energy (Origin) appreciates the opportunity to provide a response to the regulatory proposals lodged by Australian Gas Networks (AGN), Multinet Gas (Multinet) and AusNet Services (AusNet) for their Victorian gas distribution networks for the period from 1 July 2023 to 30 June 2028.

The release of the Victorian Government's Gas Substitution Roadmap (the Roadmap) has created a significant challenge for both the networks and the AER to ensure the accurate forecast of key regulatory parameters. This challenge is amplified due to the uncertainty of how and when key Roadmap initiatives will be introduced.

As a result, this will involve the AER applying its regulatory judgement. In doing so the AER must balance the risk of not providing the networks with a reasonable opportunity to recover their efficient costs with the risk of overcompensation. Neither is a preferable outcome.

However, we consider that over the longer term, under-compensation resulting from regulatory error is a greater risk. Given that the regulatory setting of prices is determined prior to ascertaining the actual operating environment that will prevail during the regulatory control period, the regulatory framework should err on the side of allowing at least the recovery of efficient costs.

Notwithstanding, given the developing policy environment, further iterations may be required prior to the release of the AER's Final Decision and potentially into the next access arrangement period to best manage this risk. It is important that the AER consider how the evolving policy can be effectively incorporated into the access arrangement in a way that promotes efficient outcomes and increased certainty for both customers and network businesses.

The AER's decision also involves the transition from a calendar year-based pricing period to financial year-based pricing period. This extends the current access arrangement period by six months, with the next access arrangement period to commence on 1 July 2023. To ensure this transition does not compromise the intended operation at retail pricing under the Victorian Energy Retail Code of Practice, it is vital that the AER provide for a transitional network price adjustment on 1 January 2023.

Finally, Origin acknowledges the customer engagement process undertaken by the Victorian networks to inform its proposal and the ongoing effort to incorporate the long-term interest of customers in its forward planning.

Origin's response to specific issues identified in the proposals are set out below.

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Gas Substitution Roadmap

Since the networks' proposals were developed, the Victorian Government released its Gas Substitution Roadmap. The Roadmap introduces measures and incentives for households to move away from gas toward electrification, removes the current planning scheme requirement that all new developments be connected to the gas network, and establishes higher energy efficiency requirements for households. While customers maintain the option of connecting to gas networks, the policy actively promotes electrification as a means of achieving decarbonisation targets for Victoria.

The Roadmap envisages a significant and relatively rapid reduction in gas consumption. This does not appear to align with the specific policies, programs and initiatives set out in the Roadmap, suggesting there are more policy initiatives in train or anticipated. The developing policy environment adds considerable uncertainty to the future of gas networks and in particular, the potential asset stranding risk.

Given the potential impact on network proposals, we believe the AER will need to reconsider the process for revision and assessment of the proposals, including the stakeholder consultation process. With potential for further refinement of gas decarbonisation policy at both the State and Federal level and consequent ongoing implications for gas networks, the AER may need to consider how it frames the forthcoming access arrangement and how the regulatory framework may need to adapt to changing circumstances. For example, we note that the National Gas Rules (clause 65) provide for a within-period variation to the access arrangement. The AER ought to review the process to determine if the variation mechanism can be appropriately applied in the event of significant and/or frequent policy change impacting networks, or if other measures are required.

Demand

The networks note that the Roadmap has yet to be fully implemented and uncertainty remains around the exact legislative and policy changes that will eventuate. While the policy intent of the Roadmap is clear, there is little detail in terms of modelling demand outcomes i.e. how customers will respond to the proposed electrification initiatives. As a result, the networks have chosen to model the impact on future demand based on the specific initiatives presented in the Roadmap rather than extrapolating based on the accompanying commentary; we consider this to be a sensible approach. However, it is clear there is an ongoing risk to gas demand and network viability and there appears to be scope for further policy changes during the access arrangement period to June 2028.

We expect ongoing policy developments to impact both the growth in customer connections and utilisation per connection. It is vital that the AER and networks ensure that demand forecasts are updated progressively as more information comes to hand and the implications for expenditure and prices as the policy environment becomes clearer. Where there are significant within-period variations in demand, the access arrangement may need to be amended to reduce the prospect of price shocks in the following regulatory period.

Capital expenditure

Irrespective of policy developments, networks are required to continue to connect customers to the gas network if requested and are obligated to maintain the safety and reliability of the networks. Accordingly, a number of capex categories, particularly replacement and IT expenditure, are forecast to be unaffected by the Roadmap policies. However, the Roadmap initiatives are expected to result in a significant reduction in new residential connections and an increase in existing customer disconnections, reducing both growth and augmentation expenditure. The net effect is a forecast reduction in aggregate capex compared to the initial proposals.

We accept that the networks are obliged to maintain network safety and reliability and consider that the networks have adopted a pragmatic forecasting approach on the basis of available information. However, it is apparent that the Roadmap and associated policy has yet to be fully articulated. Under these circumstances there is considerable downside risk to the forecasts. The challenge for the AER is not only to assess the forecasts as presented, but to provide sufficient flexibility in the regulatory regime to adapt to the changing policy environment.

Both AGN and Multinet forecast specific hydrogen readiness expenditure in the forthcoming period. In addition, the mains replacement programs have the joint benefit of enhancing network safely and reliability whilst also facilitating future hydrogen readiness. We believe that forecast expenditure should be based on meeting customer connections and ensuring network safety/reliability. We consider that expenditure to facilitate hydrogen readiness is appropriate to the extent that legislation is introduced supporting the use of hydrogen blending. We note that AusNet removed its previously proposed $11 million on readiness for hydrogen blending, recognising the current uncertainty about the future of the gas networks. AusNet will instead seek a cost pass-through if a legislative requirement for hydrogen blending is introduced in the next access arrangement period. We consider that this is an appropriate strategy under the circumstances.

In assessing forecast capex and in particular growth-related capex, the AER needs to be cognisant of the uncertain future facing the gas sector and the potential asset stranding risk associated with forecast capex. We consider the AER's assessment of proposed capex should recognise the uncertainty surrounding the future of the gas networks whilst also seek to limit exposure to potential asset stranding risk.

Operating expenditure

AGN and Multinet forecast an increase in opex citing generally higher input costs, while AusNet forecasts opex similar to the current access arrangement period. Each of the networks anticipate minimal change to opex forecasts as a result of the Roadmap with the key implication being a reduction in the trend component as a result of reduced demand. The networks have also reduced productivity growth from 0.4 to 0 per cent per annum noting that productivity improvements are unlikely under the revised policy. We consider this to be a reasonable approach given the networks are no longer expected to grow. While marginal productivity improvements are likely to be available, opportunities to efficiently invest in new technologies and other programs to substantially increase productivity are expected to be limited where demand is declining.

The opex forecast methodologies appear reasonable, and we note that the businesses have actively reduced expenditure in response to stakeholder feedback received throughout the engagement process. As with capex forecasts, it may be necessary for opex forecasts to be revised within the access arrangement period in response to developing policy developments.

The network businesses propose to expense several overheads that are currently treated as capital overheads. Appropriate cost allocation is a fundamental component of regulatory accounts. In recent access arrangements we note the ease with which costs are migrated between expensing and capitalising and vice versa seemingly with little reference to cost causation. We consider that cost allocation should be based on the principle of causation. That is, costs are required to be attributed in accordance with the activities which cause the costs to be incurred.

Regulatory accounts are special purpose accounts prepared to provide financial information about the regulated business for use by the regulator, the industry, consumers and other stakeholders. They provide information that is more focused than that contained in statutory accounts as they relate to the regulated businesses or activities. Appropriate and consistent cost allocation is a fundamental component of regulatory accounts. Consistent cost allocation is necessary to facilitate comparison across time periods and for determining potential efficiency and incentive outcomes. We consider that changes to cost allocation should only occur in exceptional circumstances rather than as a tool for affecting changes in aggregate capex or opex. We request that the AER adopt a more principled approach to cost allocation to ensure compliance with accepted cost allocation principles and maintain expenditure comparability over time.

Accelerated depreciation

The network businesses have proposed a program of accelerated depreciation as a means of maintaining the future viability / affordability of the networks while recognising potential asset stranding in the face of an uncertain future. We note that the AER have previously identified the use of accelerated depreciation as an appropriate means of addressing the uncertainty facing gas networks (provided there is sufficient evidence to demonstrate and quantify the pricing risk and stranded asset risk arising from demand uncertainty).[1]

The asset stranding risk that the gas networks face has materially increased under the Roadmap. The scenarios where the network would not end up stranded are now less likely to occur. The networks developed detailed models to examine future network scenarios and propose an approach to accelerated depreciation that aims to balance price impacts (both short and long-term) with the risk of asset stranding. The lack of detail in the Roadmap and uncertainty in the extent and pace of decline in gas demand means that the development of the scenarios requires substantial judgement. We consider that the businesses have appropriately interpreted the available information and the implied impact on demand is reasonable. Further, the networks have struck an appropriate balance between the interests of network owners and network customers, proposing a reasonable amount of accelerated depreciation whilst aiming to minimise price impacts in the forthcoming access arrangement period. The strategy leaves the businesses better placed to respond to the evolving policy environment without significantly impacting customers.

As the policy environment and the path to decarbonisation becomes clearer, it may be that the approach to depreciation needs to be adjusted or that other measures are required. It is important that the regulatory framework is sufficiently flexible to accommodate the changing policy environment and allows network businesses to respond in an effective and timely manner.

Ancillary services

AGN proposes a significant increase in a number of ancillary reference service charges. For example, the charge for ‘meter removal’ increases from $100 in the current access arrangement period to a proposed $124. Further, a number of charges for AGN appear considerably higher than corresponding charges for Multinet. For example, AGN proposes a disconnection charge of $87 compared to $62.72 for Multinet. We request that AGN provide an explanation for the increase in ancillary service charges.

As part of the update, AGN and Multinet propose to add an additional ancillary reference service; ‘service abolishment – residential’ to accommodate the anticipated increase in permanent disconnections arising from the Roadmap initiatives. We appreciate the need for the new service category but are concerned that the associated fee ($950) may act as a disincentive for customers to disconnect and potentially undermine the intent of the Roadmap initiatives. We request that the AER review the proposed charges (and the comparable AusNet charge) to determine the efficiency of the charge and its potential impact on a customer’s decision to abolish the existing service.

Terms and conditions

Origin supports the proposal to align the services and terms and conditions across AGN and Multinet in Victoria.

AGN indicates that it will no longer charge retailers the distribution fixed charge for zero consuming meters that have been plugged (disconnected sites). This would align the practice of AGN to Multinet and other distributors. Origin strongly supports this position.

1 January 2023 variation

The Victorian Government (Order in Council) has determined to move the access arrangement periods of the state's gas distribution businesses from a calendar year access arrangement period to a financial year basis. Accordingly, the next access arrangement period will commence on 1 July 2023. The Order provides that the six month period of 1 January 2023 to 30 June 2023 is taken to be an extra regulatory year of the 2018-2022 access arrangements.

[1] AER, Regulating Gas Pipelines under Uncertainty, November 2021, p. 44.

The AER's Draft Decision on the 1 January to 30 June 2023 extension period (July 2022) indicates that current, 2022 network prices will be adjusted by CPI to cover the six month extension period and a true-up will occur in the 2023–28 period to reflect any difference between allowed revenue under the extended, 2022 tariffs and the trended forward building block revenue calculation. Network prices will therefore change on 1 January 2023 to reflect actual CPI.

Origin strongly supports the change to network tariffs on 1 January 2023 to ensure network regulation continues to operate in concert with the intent of the Energy Retail Code of Practice (Cl. 94(2)) – that a retailer must not increase any of the tariffs payable by a small customer under a market retail contract except with effect from a network tariff change date.

Without a change to network tariffs on 1 January 2023, we are concerned retailers will be prevented from changing their market offers in February 2023. Given the significant price volatility currently experienced in gas markets, not allowing retailers to manage this price volatility through price changes in February 2023 will put substantial financial pressure on retailers and potentially lead to further retailer failures.

If you have any questions regarding this submission, please contact Gary Davies in the first instance at gary.davies@originenergy.com.au.

Yours sincerely

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