Submission No 33

DOWNSTREAM GAS SUPPLY AND AVAILABILITY IN NSW

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Date Received:	20/06/2013

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19 June 2013

Mr Andrew Gee MP
Chair
State and Regional Development Committee
Parliament House
Macquarie Street
Sydney NSW 2000

Envestra

Dear Mr Gee

Inquiry into the Downstream Gas Supply and Availability in NSW

Thank you for your letter dated 16 April inviting Envestra to address the terms of reference to the inquiry into downstream gas supply and availability in NSW.

By way of background, Envestra is Australia's leading natural gas distribution business, delivering 120 PJ of gas to 1.2 million customers across New South Wales, South Australia, Victoria, Queensland and the Northern Territory. Envestra owns approximately 22,000 km of natural gas distribution networks and 1,100 km of transmission pipelines.

Envestra's vision is to own and reliably operate natural gas networks, pipelines and related services that generate attractive returns to our shareholders.

Envestra considers that it is well placed to comment on the terms of reference to the inquiry into downstream gas supply and availability in NSW. The ability to have access to cost competitive sources of natural gas not only provides strong support for economic development but plays an important role in Australia's transition to a low carbon economy.

There are currently significant challenges faced by investors in expanding natural gas distribution networks, particularly to regional areas. This reflects the large sunk costs of providing the necessary infrastructure along with, in the current environment, concerns over the expected large increases in the wholesale cost of gas and recently observed declining average consumption.

Envestra considers that there are clear steps that Governments can take to overcome these challenges, ranging from policies aimed at encouraging greater gas use (thereby improving the economics of gas supply) to directly encouraging infrastructure provision (by subsidising the cost of the infrastructure). These issues are discussed in greater detail in the submission attached to this letter.

We are keen to actively participate in the inquiry and would encourage you to contact either myself [redacted] or Craig de Laine [redacted] if you would like to discuss these matters further.

Yours sincerely

[redacted]

Ian Little
Managing Director

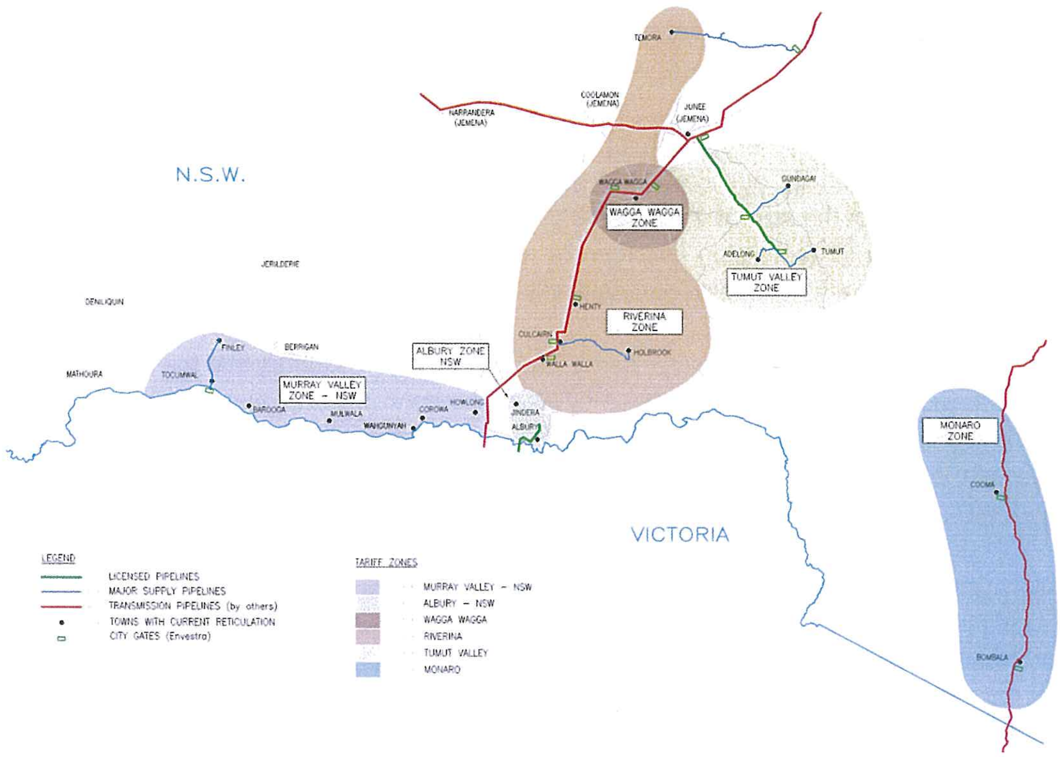
Response to the Inquiry Terms of Reference

This attachment sets out Envestra's comments on each of the specific terms of reference set by the State and Regional Development Committee (the Committee).

(a) the adequacy of transmission pipeline systems and distribution networks for future gas needs and supply challenges

Envestra currently has gas networks in NSW that supply gas to around 50,000 consumers in the southern parts of the state. The two largest networks are in the towns of Albury and Wagga Wagga, with the latter acquired from Country Energy in October 2010. A map setting out Envestra's networks in southern NSW is provided below for the information of the Committee.

Envestra Natural Gas Distribution Operations in Southern NSW



Envestra has no capacity constraints within its own networks that would restrict the continued growth of customer connections and/or usage. To the contrary, in the case of our Wagga Wagga network average capacity utilisation is only around 20%. Envestra is keen to work with the NSW Government to explore the potential for greater domestic and industrial customer connection to the Wagga Wagga network.

Envestra does not foresee the potential for network constraints arising from the significant developments brought on by the establishment of a LNG export industry in regards to the supply of gas to its regional NSW networks. Supply difficulties are most likely to arise with transmission constraints, or upstream supply difficulties in our other state based networks in South Australia and Queensland.

(b) barriers to the expansion of downstream gas supply and distribution networks

The most considerable barrier to the expansion/development of natural gas networks is the large sunk costs associated with providing the requisite infrastructure. This matter is compounded in regional areas due to the often large distances between demand centres and existing pipeline infrastructure.

In addition, network companies building new gas infrastructure in established regional towns (brownfield developments) typically face higher construction costs relative to the more traditional greenfield developments (e.g. due to the need to work with, and around, existing infrastructure and the required reinstatement costs). Regional towns also tend to have relatively low populations and low demand growth, especially where potential customers have alternative energy supplies (such as electricity and bottled LPG).

These matters are further compounded by investor concerns over:

- the substantial forecast increases in the wholesale price of gas in Australia, with ACIL Tasman recently forecasting that wholesale gas prices in NSW will increase by as much as 50% by 2015/16[1]; and
- the trend for declining average consumption of natural gas (bought on by shifts in consumer preferences to electrical appliances and the milder weather experienced over the past decade) and the closure of many large gas fed manufacturing operations over the recent period.

Such factors make it increasingly difficult (and risky) for private investors to provide the funding necessary to expand/develop natural gas networks.

A further factor impeding the expansion of downstream gas distribution networks is the prescriptive regulatory framework and its application. Most downstream natural gas networks are subject to full regulation, regardless of the size of the network and energy market dynamics. The prescriptive nature of full regulation is costly to administer, which costs are largely independent of network size. These costs represent a further barrier to extending gas networks.

In terms of its application, the Australian Energy Regulator (AER) assumes that the risk characteristics of natural gas networks are the same as those of electricity networks. For example, the rate of return for electricity and gas networks is set using the same methodology. However, when the factors noted above are taken into account, it is clear that the risks of extending gas networks will be higher than those associated with electricity networks primarily due to the discretionary nature of natural gas.

Fortunately, the National Gas Law also provides for light handed regulation. To this end, Envestra has recently submitted an application to the National Competition Council (NCC) to have regulation removed from our Wagga Wagga distribution network.[2] The key reason supporting this application is that Envestra does not have the incentive, or the ability, to act in a manner that is contrary to the long term interests of consumers. This reflects that:

- prices are constrained by the ability for consumers to readily substitute electricity in preference to gas (which will become an increasing issue given the projected increase in wholesale gas prices mentioned earlier);
- the competitive position of natural gas relative to electricity is currently marginal in Wagga Wagga and is expected to worsen as a result of the projected increases to wholesale gas prices;
- pricing decisions are further constrained by the countervailing market power of retailers and our large industrial customers; and
- there exists a strong incentive to increase throughput on the network given the large sunk costs, low network utilisation and lack of any competitive advantage from using gas relative to electricity (increasing throughput has the effect of lowering the prices charged for gas supply).

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1 The ACIL Tasman report can be found at: http://www.ipart.nsw.gov.au/Home/Industries/Gas/Reviews/Retail_Pricing.

2 Envestra's application to the NCC can be found at: http://www.ncc.gov.au/index.php/application/revocation_of_coverage_of_the_wagga_wagga_natural_gas_distribution_network.

Envestra therefore considers that the costs of regulation for this network are not warranted given the lack of tangible benefits to consumers arising from that regulation.

The NCC released its Draft Recommendation into this matter on 17 June, which decision did not accept Envestra's application for coverage to be revoked. The NCC formed the view that a covered network was likely to encourage greater retailer participation in the market if retail price regulation is removed in NSW. Envestra disagrees with this assertion and notes that the NCC did not consider to any great extent the significant constraint on pricing arising from the cost of gas relative to electricity.

Envestra had intended to pass back to customers the full amount of regulatory costs that are included in current prices if regulation were removed. This would have occurred by not applying the approved 2.5% real increase in regulated network tariffs on 1 July 2014 and by limiting further tariff increases to be no greater than the CPI over the following 5 year period.[3] The NCC however stated that it could place limited weight on these outcomes in its assessment.

Envestra intends to make a submission to the NCC by the required time for submissions of 8 July 2013. The NCC will then make a final recommendation to the relevant Minister, which in this case is the NSW Minister for Resources and Energy (the Minister), as to whether regulation should be removed. The Minister must then decide whether to remove regulation from the Wagga Wagga network.

Envestra considers that, if the NCC were to uphold its draft recommendation and the Minister were to accept this advice, that a key opportunity has been lost to not only provide better price outcomes to customers but also to create an environment that is more conducive to further investment and retail competition. This outcome would be counter to the Government's objective of reducing "red-tape" where it is not required.

Finally, barriers to the expansion of gas distribution networks can be minimised by harmonising technical and safety practices across states. For example, Envestra had great difficulty some years ago in persuading the NSW Office of Fair Trading that gas meters tested and labelled to Victorian standards were suitable for NSW consumers. Harmonisation of technical regulation or acceptance of interstate regulatory practices would assist in minimising barriers to efficient network operations and expansion.

(c) the effectiveness of competition in the downstream gas market and consumer pricing implications;

Envestra has provided a confidential attachment to this submission setting out the market share of retailers within our southern NSW networks.

(d) the effectiveness of existing protections for consumers and measures to facilitate access to gas connection and supply;

Envestra provides open, transparent and non-discriminatory access to users across all of its regulated and unregulated gas distribution networks. Indeed, there is a strong incentive for Envestra to encourage greater customer connections and usage of its distribution networks given the discretionary nature of natural gas.

The COAG in 2002 conducted a review of the energy market and devised a set of reforms intended to nationally harmonise jurisdictional arrangements and enhance consumer protections, which led to the development of the National Energy Customer Framework (NECF), a legislative package aimed at regulating the sale and supply of energy to consumers. Many aspects of the NECF are due to come into effect in NSW on 1 July 2013.

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3 This proposed pricing policy compares favourably to price outcomes achieved on our regulated networks, with average annual approved tariff increases of around 5% set in Envestra's current Access Arrangements.

Envestra also notes that consumer ombudsman schemes operate across all jurisdictions where Envestra operates, which provides an avenue for consumers to seek to resolve disputes in the event they are not resolved with their retailer or distributor. Envestra notes that complaints regarding its services represent a very low share of overall complaints received by the Ombudsman.

For example, there were only 155 complaints registered with the Ombudsman in 2011/12 from Envestra's 1.2 million customers. The majority of these complaints were related to very minor issues that could have been more efficiently resolved if customers had not had to confront communication difficulties arising from contacting their retailer for those complaints that were best handled by Envestra (thereby avoiding unnecessary and sometimes lengthy call times).

(e) possible measures to encourage gas network operators to extend existing distribution networks, including financial incentives of licence obligations, particularly in regional centres that do not have access to reticulated gas.

As noted earlier, there are a range of barriers to the ongoing expansion and development of natural gas distribution networks. These barriers include the large sunk costs of providing the infrastructure, particularly to regional areas, concerns over cost recovery given the trend of declining average consumption and the preferential subsidies/rebates applying to certain renewable energy appliances (i.e. solar).

There are however a range of measures, in addition to removing regulation where it is no longer warranted, that can be taken by Governments to address these known barriers to the further expansion/development of natural gas networks. These measures relate to policy designed at overcoming the often prohibitive cost of providing network infrastructure and policy aimed at encouraging greater gas usage.

With regard to the supply of infrastructure, the Victorian Government has been very proactive in encouraging the supply of natural gas in regional areas. The Victorian Government's "Energy for the Regions Program" provides $100 million aimed at overcoming the barriers to network expansion by directly subsidising gas infrastructure to regional areas.

Access to natural gas is seen by the Victorian Government as a key driver of sustainable economic growth for those regional communities. Upon winning the 2011 election, the Government stated the objective of the Energy for the Regions Program as follows:

> *"The Energy for the Regions Program will invest $100 million to expand natural gas to communities across regional and rural Victoria. Funded by the Victorian Government's $1 billion Regional Growth Fund, the Program will drive new investment in regional communities through new industry and business opportunities."*

The Government gave Regional Development Victoria (RDV) the task of implementing this policy. The RDV initially identified 12 "priority towns" and began the process of inviting submission to supply and reticulate these towns with natural gas. There are three overlapping work streams as part of the policy:

- offering a fixed subsidy or 'bounty' to gas distributors to connect the priority towns using conventional pipeline technology;
- the design of a tender for development of a gas supply for regional Victoria using compressed natural gas (CNG) or liquefied natural gas (LNG) facilities; and
- the facilitation and establishment of local reticulation networks in priority towns where gas distributors are not willing to deliver gas to these communities via a traditional trunk pipeline.

The Energy for the Regions program has seen RDV enter into agreements for the supply and reticulation of natural gas to a number of the identified priority towns. Envestra is currently in advanced negotiations with RDV in respect of two towns. Envestra has also already entered into a binding agreement in respect of expanding the capacity of our unregulated Mildura network.

The announcement of the increase in capacity to Mildura has already seen one major fruit juice producer move its operations closer into the town so that it can connect to the natural gas distribution network in order to lower its energy costs. This provides an example of the impact that access to lower energy costs can have to economic development in regional centres.

Envestra notes that the Energy for the Regions program is the second time the Victorian Government has, in recent history, provided funding to expand access to natural gas in regional areas. In 2003, through the financial commitment of $70 million to the Natural Gas Extension Program (NGEP), the Victorian Government also sought to facilitate the expansion of the natural gas network.

As a result, the NGEP saw Envestra extend its network and connect eight towns in regional Victoria, including in Bairnsdale, Paynesville, Balnarring, Balnarring Beach, Merricks Beach, Somers, St Andrews Beach and Hurstbridge. These towns would not have been connected to natural gas had it not been for the NGEP as the required investment was not allowed under the National Gas Rules (as the investment would have failed the economic feasibility test).

As evidenced by its participation in the Victorian Government schemes, Envestra is motivated to expand its network to regional communities. The evidence suggests that such expansions have led to strong domestic gas volume and economic growth and will play an important role in reducing the carbon intensity of the economy.

Envestra also considers that it is crucial for government policy to support the greater use of natural gas, or in the very least, design policy that does not discriminate against its use. This is crucially important to ensuring that natural gas, which is a discretionary fuel for most applications, remains economic over the long term. Such policy might include:

- promoting the greater supply of natural gas where it is available – which could include encouraging greater exploration/supply of natural gas resources or removing impediments to gas reservoir development (e.g. by removing unnecessary environmental restrictions on coal seam gas projects) to ensure a cost competitive and readily available supply of natural gas for consumers;
- promoting the greater use of natural gas where it is available – which could include policies aimed at encouraging natural gas hot water use and longer term measures aimed at encouraging the greater development and use of available technologies such as gas fired air-conditioning and natural gas vehicles. Such policies will also assist to reduce greenhouse gas emissions;
- removing regulation where it is not warranted – as discussed earlier, which will strengthen the incentives to invest in gas networks and lower costs to consumers; and
- subsidising the reticulation of natural gas and/or providing subsidies to encourage consumers to convert appliances to natural gas, both of which would encourage sustainable economic development, particularly in regional areas. To this end, current rebates that favour the installation of solar and heat pump hot water over gas should, as a minimum, be removed.

An example of where government policy can simply and effectively assist the development of downstream infrastructure relates to hot water policy, which is essential for the economic viability of natural gas networks. A recent example of such policy for various governments was to ban electric hot water systems, which policy is consistent with the COAG decision to phase out emissions intensive hot water systems following a Regulatory Impact Statement (RIS) into the cost and benefits of such a policy. The key benefits of this policy include:

- promoting environmentally sustainable economic growth (and lowering carbon emissions more generally);
- assists in reducing expenditure associated with meeting peak demand on electricity networks (as would rebates to, for example, consumers buying gas fired air-conditioners or gas fired generators); and
- significantly reducing the risks associated with expanding gas networks (by increasing the likelihood that new network extensions will attract gas hot water appliance use).

Envestra believes that implementation of the COAG policy to phase out emission intensive hot water systems for customers on a line of main is the simplest policy response that the NSW government would serve to promote the further development of gas distribution infrastructure, particularly given the RIS has been completed. As a minimum, Envestra considers rebates that favour the use of other applications, such as solar and/or heat pumps, should be removed.

Envestra considers that such policy responses are justified for a range of reasons, including ensuring equal access to services for the community regardless of their location, encouraging lower cost energy supplies for consumers, promoting economic growth, ensuring better utilisation of available infrastructure, ensuring better use of available natural resources, reducing peak demand (and hence costly investment) on the electricity networks and moving towards a lower carbon intensive economy.