Attachment 7.10

Response to Draft Decision on Operating Expenditure

SA revised Final Plan July 2021 – June 2026

January 2021

Australian Gas Networks

1. Response to Draft Decision on Operating Expenditure

The operating expenditure (opex) we incur supports the safe, efficient and reliable delivery of gas to homes and businesses every day. It ensures we can meet the service expectations of our customers and the day-to-day needs of our workforce.

1.1. Overview

This attachment sets out our response to the AER's Draft Decision on operating expenditure (opex) for the AGN SA network over the next (2021/22 to 25/2026) Access Arrangement (AA) period.

The revised Final Plan forecast opex for the next AA period is $351 million, which $21 million (or 6%) higher than the forecast opex in the AER's Draft Decision but $7 million (or 2%) lower than our original Final Plan submitted July 2021 and on account of:

- Updated for actual operating expenditure incurred in 2019/20 ($7 million);
- Inclusion of our proposed Vulnerable Customer Assistance Program (VCAP) as a category specific forecast and the digital customer and insurance step changes, for which we have provided additional supporting information ($8 million) consistent with our Final Plan;
- Updated inflation, escalation and customer number forecasts ($5 million); and
- Accounting for the cost of purchasing renewable gas to meet our UAFG requirements in the opex forecast, rather than to rely solely on the annual tariff variation mechanism ($1 million).

Table 1.1 below summarises our revised opex forecast compared to our Final Plan and the AER's Draft Decision, including the key drivers for change.

Table 1.1: Summary of revised opex forecast ($million, 2020/21)

	Final Plan	AER Draft Decision	Revised Final Plan	Drivers for change
Opex (ex UAFG & VCAP)	306.3	290.5	307.0	✓ We have provided further support for our Final Plan position on step changes for digital customer services and insurance premia ✓ We have updated base year opex for 2019/20 actuals ✓ We have used forecast inflation for 2020/21 from the RBA's November statement on monetary policy ✓ We have updated the trend applied to our base year costs to reflect: • Updated advice on forecast labour costs from BIS Oxford Economics • Changes in output growth associated with updated new connection numbers (including that we have decided not to proceed with the extension of our network to Mt Barker)

	Final Plan	AER Draft Decision	Revised Final Plan	Drivers for change
Proposed change in capitalisation	-	-	-	✓ We have maintained our Final Plan position not to reduce the level of overheads that are capitalised into our asset base but consider this should be looked at in the subsequent AA period
UAFG	47.2	38.9	40.4	✓ We have accepted the AER's Draft Decision for forecast volumes based on the average of the last two years of settled data ✓ We have accounted for the forecast cost of purchasing renewable UAFG in our opex forecast
VCAP	3.9	-	3.9	✓ We are now proposing our VCAP as a category specific forecast
Total opex	**357.4**	**329.4**	**351.3**	

1.2. Stakeholder and customer feedback

In preparing the revised Final Plan we have continued to engage with stakeholders, including our Reference Groups and through consideration of submissions to the AER on our Final Plan. We have also undertaken dedicated engagement on our VCAP with members of our SA Reference Group, Retailer Reference Group and the co-design team to respond to feedback through submissions to the AER on our Final Plan.

A summary of the feedback provided on our opex is provided in Table 1.2 below.

Table 1.2: Summary of customer and stakeholder feedback

Customer and Stakeholder Feedback	Our Response
On our proposed Base year opex: • CCP24 is looking to the AER to assess its efficiency and noted it was encouraging to see that gas networks are developing their own benchmark data given that the AER has relatively less data to assess gas network efficiency.[1] • ECA supported the use of 2019/20 opex as the base year.[2]	We have updated our base year to reflect actual 2019/20 opex as reported in our recent RIN submission.
On the Trend: • CCP24 expects that forecasts for the labour cost assumptions will be revised prior to the AER's final decision to reflect COVID-19 impacts. Origin stated that it is unclear that the BIS Oxford forecasts incorporate the impact of COVID-19.[3]	• We have updated our labour growth forecasts to account for COVID-19 impacts. • We have continued to apply a productivity factor of 0.4%.

[1] CCP24, Advice to AER on AGN Final Plan for AGN Gas Networks (South Australia) Access Arrangement July 2021-June 2026, 10 August 2020 (CCP24 Submission), p. 24.
[2] ECA, Submission on AGN 2021-26 AA Proposal, August 2020 (ECA Submission), p. 14.
[3] CCP24 Submission, p. 28, Origin, Submission on AGN 2021-26 AA Proposal, August 2020 (Origin Submission), p. 2.

Customer and Stakeholder Feedback	Our Response
• ECA and Origin supported application of a productivity growth factor, but Origin noted it was hard to assess the quantum without appropriate productivity benchmarking. ECA said that the AER should satisfy itself that the factor should not align with the factor used for electricity businesses.[4] • EnergyAustralia observed that our productivity factor should be compared with other network businesses and that other factors affecting trend adjustments likely need to be reconsidered in light of COVID-19 impacts.[5] • Business SA supported 0.4% productivity adjustment, but could be 0.5% to align with that imposed on electricity distribution companies.[6]	
On our Vulnerable Customer Assistance Program step change, most stakeholders and customers were supportive of AGN playing a role in supporting consumers.[7] Some had questions around: • The relationship to other programs and whether there was a duplication[8]; • Program design, specifically whether we had the right mix of support services, it is cost-effective, fit for purpose and appropriate;[9] and • How the program could and should be funded.[10]	We are continuing to propose the VCAP proposal but as a category specific forecast as recommended by the AER. We have and will continue to engage with our customers and stakeholders on the delivery of the VCAP.
On our Digital Customer Experience project step change: • CCP24 observed this proposal was supported by consumer engagement and is consistent with our proven record in actively seeking to improve interaction with customers.[11] • EnergyAustralia observed that upgrades in relation to digital communication channels would provide a better customer experience.[12]	We have maintained our proposal for the Digital Customer Experience project as an opex step change. This project represents a new activity developed in response to feedback through our customer and stakeholder engagement program. It is a distinct uplift in services (rather than a refinement of our existing services) and should be captured through additional opex rather than through the forecast rate of change.
On our increases to insurance premia step change:	We are continuing to propose increases to insurance premia as a step change as our insurance premia are forecast to increase above the trend over the next AA period due to a hardening of the cycle for commercial insurance.

[4] Origin Submission, p.2, ECA Submission, p. 15.
[5] EnergyAustralia, Submission on AGN 2021-26 AA Proposal, August 2020 (EnergyAustralia Submission), p. 2.
[6] Business SA, Submission on AGN 2021-26 AA Proposal, August 2020 (Business SA Submission), p. 2.
[7] SAFCA, Submission re AGN SA gas access arrangement proposal for the period 1 July 2021 to 30 June 2026, 7 August 2020 (SAFCA Submission), p. 3, SAFRRA, AGN SA 2021-26 Gas AA Review, 10 August 2020 (SAFRRA Submission), p. 1, EWOSA, Submission to the AER's consultation on the AGN SA Access Arrangement 2021-26, 6 August 2020 (EWOSA Submission), p. 2.
[8] ECA Submission, pp. 16-17, SA Minister for Energy and Mining, Submission on AGN SA Access Arrangement for 2021/22 to 2025/26, 3 August 2020, p. 3.
[9] ECA Submission, pp. 16-17, SACOSS Submission, pp. 3-6.
[10] SACOSS Submission, pp. 3-6.
[11] CCP24 Submission, p. 27.
[12] EnergyAustralia Submission, p. 2.

Customer and Stakeholder Feedback	Our Response
• both SACOSS and ECA stated that the AER should consider whether insurance premiums should be reflected as part of the tariff variation mechanism.[13] • CCP24 stated that the AER should review and assess whether additional costs over the trend are justifiable and noted it is justifiable if insurance increases are substantially greater than an efficient business would be expected to budget for.[14]	
On our UAFG forecasts: • ECA considered that the AER should review the method we estimate the cost of gas, our contract arrangements with our renewable gas supplier and what competitive tensions exist in terms of suppliers of renewable or carbon neutral gas.[15] • CCP24 and EnergyAustralia suggested that the AER should consider how we might have greater incentives to minimise costs.[16] • EnergyAustralia noted we may need to reconsider the renewable gas initiative in light of COVID.[17] • SACOSS is interested in understanding the merits of capping UAFG at a maximum price noting the consumers are supportive of renewable UAFG only to the extent it increases bills up to a certain amount.[18]	We have accepted the AER's Draft Decision on the approach to setting forecast UAFG volumes. This and slightly lower prices based on market prices for replacement gas (even when including some replacement gas from renewable sources), sees total UAFG costs $7 million lower than proposed in our Final Plan, and consistent with levels seen in the current AA period.

We engaged with the SARG and RRG on 9 December 2020 on our proposed approach in this revised Final Plan, and our members supported that we:

- Update the 2019/20 base year for actuals;
- Provide updated independent advice on the labour price growth from BIS Oxford;
- Provide additional information on our VCAP proposal having undertaken further engagement with our SARG, RRG and co-design team; and
- Accept UAFG volumes but noting the renewable UAFG price is largely known and should be included in the AER's Final Decision.

1.3. AER Draft Decision

The AER's total opex forecast of $329 million is $28 million ($2020/21) or 8% lower than our Final Plan forecast of $357 million. The decrease to forecast opex for the next AA period compared to our Final Plan is mainly related to:

- Using a more recent inflation forecast from the Reserve Bank of Australia in its estimates;

[13] ECA Submission, p. 15, SACOSS, Submission on AGN 2021-26 AA Proposal, August 2020 (SACOSS Submission), p. 3.
[14] CCP24 Submission, p. 27.
[15] ECA Submission, p. 14.
[16] CCP24 Submission, p. 32, EnergyAustralia Submission, p. 2.
[17] EnergyAustralia Submission, p. 2.
[18] SACOSS Submission, p. 8.

- Applying a lower labour price growth rate due to the latest information available on COVID-19 impacts and increases in super guarantees (-$6 million);
- Rejecting our proposed step changes relating to the VCAP, the Digital Customer Experience project and increase in insurance premiums (-$8 million); and
- Adjustment to our UAFG forecast costs (-$8 million) to account for:
    - Lower forecast UAFG volumes and price
    - Allowing up to 150TJ of our UAFG requirements to be replaced by renewable gas (to be recovered through annual tariff adjustments).

We have provided a summary of the AER's Draft Decision in respect of our opex for the next AA period in Table 1.3 below.

Table 1.3: Summary of the AER's Draft Decision on our opex

	AER Draft Decision	AER Comment
Base year	**Accept**	Accepted 2019-20 as the appropriate base year from which to forecast opex for the next AA period.[19]
Input cost escalation	**Modify**	• Applied a lower real average annual price growth of -0.04% by:[20] ◦ only using Deloitte forecast WPI as it reflects the only available forecast accounting for COVID-19 impact at the time of the Draft Decision and would provide the best possible forecast of labour price growth; and ◦ accounting for the legislated increases in the superannuation guarantee. • Applied the same forecast non-labour real price growth rate of zero.[21] • Applied the same weights to account for the proportion of opex that is labour and non-labour (59.7% and 40.3% respectively).[22]
Output growth	**Accept**	• Adopted our approach to forecast output growth with a forecast annual growth of 0.86%, compared to 0.85% proposed.[23] • Found that our forecast average annual output growth (net of productivity growth) fell within the acceptable range of forecast output growth.[24]
Productivity factor	**Accept**	Accepted our proposed annual productivity growth rate of 0.4%.[25]

[19] AER, Draft Decision, Attachment 6, pp. 20-24.
[20] AER, Draft Decision, Attachment 6, pp. 25-27.
[21] AER, Draft Decision, Attachment 6, p. 25.
[22] AER, Draft Decision, Attachment 6, p. 25.
[23] AER, Draft Decision, Attachment 6, p. 27.
[24] AER, Draft Decision, Attachment 6, pp. 27-28.
[25] AER, Draft Decision, Attachment 6, p. 29.

	AER Draft Decision	AER Comment
Vulnerable Consumer Assistance Program	**Reject**	Is satisfied of the customer support for the Vulnerable Consumer Assistance Program (VCAP) but did not approve VCAP either as a step change or a category specific forecast.[26] The AER needs further information showing that VCAP would materially increase the quantity or quality of services we provide. The AER encouraged us to undertake further co-design with stakeholders and provide further information in support of the VCAP.
Digital Customer Experience	**Reject**	Did not approve the Digital Customer Experience (CRM) either as a step change or a category specific forecast as it was not satisfied the additional opex is required to deliver additional online services to customers.[27] The proposed service improvements are a refinement of services. Also it currently provides and is consistent with gradual improvement of good industry practice. The AER does not consider the step change to be material and could be compensated through the forecast rate of change.
Increase in insurance premium	**Reject**	Did not approve our step change for an incremental increase on our insurance premiums as:[28] • increasing insurance costs would be captured through non-labour price growth by CPI. To the extent that insurance premiums rise by more than CPI, the AER expects this will to an extent be offset by other non-labour costs rising by less than CPI; • the insurance premium increases are not related to a new regulatory obligation or a capex/opex substitution; and • the circumstances we face in the insurance liability market is not sufficiently exceptional that it would materially change our total opex over time beyond what is captured through our price growth forecast.
UAFG	**Modify**	Reduced our UAFG costs to $38.9 million over the next AA period due to the difference in estimating:[29] • Volumes – The AER agreed with Zincara's recommendation to use a forecast of UAFG based on a two year average of UAFG 2016-17 settled volumes and 2017-18 volumes which are almost settled. This accounts for the downward trend in UAFG as a result of our mains replacement program; and

[26] AER, Draft Decision, Attachment 6, p. 33-35.
[27] AER, Draft Decision, Attachment 6, pp. 31-33.
[28] AER, Draft Decision, Attachment 6, pp. 35-36.
[29] AER, Draft Decision, Attachment 6, pp. 37-40.

	AER Draft Decision	AER Comment
		• The forecast cost of replacement gas has been updated for market offer price and does not factor in the purchase of a portion of gas from renewable sources. While the AER recognises that our customer engagement demonstrated consumer support, we can be compensated for any additional costs under the tariff variation mechanism.
Debt raising costs	**Accept**	Accept our debt raising cost of $4.4m for the next AA period.[30]

Note: In this 'traffic light' table, green shading represents the AER's acceptance of our Final Plan, orange represents the AER's modification of our Final Plan and red shading represents the AER's rejection of our Final Plan.

1.4. Our Response to the Draft Decision

The revised Final Plan forecast opex for the next AA period is $351 million, which is $6 million lower than our Final Plan and $22 million higher than the AER's Draft Decision forecast opex on account of:

- Updated for actual operating expenditure incurred in 2019/20 submitted ($7 million);
- Inclusion of our proposed VCAP as a category specific forecast and the digital customer experience project and increase in insurance premia as step changes, which we have provided additional support for consistent with the Final Plan ($8 million);
- Updated inflation, escalation and customer number forecasts ($6 million); and
- Accounting for the cost of purchasing renewable gas to meet our UAFG requirements in the opex forecast, rather than to rely solely on the annual tariff variation mechanism ($1 million).

A summary of our response to the AER's Draft's Decision is provided in Table 1.4 below.

Table 1.4: Summary of our response to the AER's Draft Decision on our opex

	AER Draft Decision	Our response	Our Comment
Base year	**Accept**	**Accept**	We have accepted the AER's Draft Decision and have updated our base year to reflect actual 2019/20 opex as reported in our recent RIN submission. We have also updated 2020/21 inflation for the RBA's forecast in its November statement of monetary policy.
Input cost escalation	**Modify**	**Modify**	We have modified the AER's Draft Decision by including updated advice from BIS Oxford on real labour price growth over the next AA period in the calculation of input cost escalation. More information on BIS Oxford's forecasts can be found in Attachment 7.3A.

[30] AER, Draft Decision, Attachment 6, p. 37.

	AER Draft Decision	Our response	Our Comment
			We have continued to apply a material costs growth rate of zero consistent with our Final Plan and the AER's Draft Decision.
Output growth	**Accept**	**Accept**	We have updated the output growth factor over the next AA period to reflect updates in forecast growth in: • Customer numbers; and • Kilometres of mains in the network. More information on the updates to customer numbers and kilometres of mains can be found in Attachments 8.7A, 8.11, 12.1A and 12.2A.
Productivity factor	**Accept**	**Accept**	We have accepted the AER's Draft Decision and have not proposed any further changes.
Vulnerable Consumer Assistance Program	**Reject**	**Reject**	We have included the VCAP as a category specific forecast. We have undertaken further engagement with stakeholders and have demonstrated the program does not duplicate any existing programs and will provide a material increase in service levels for these customers. More information on our VCAP can be found in Attachment 7.2A.
Digital Customer Experience	**Reject**	**Reject**	We are continuing to propose the opex costs associated with the Digital Customer Experience Project as a step change. More information in support of this can be found in section 1.4.3.1 below.
Increase in insurance premiums	**Reject**	**Reject**	We are continuing to seek a step change on account of increases to insurance premia that are not captured within the forecast rate of change. More information in support of this can be found in section 1.4.3.2 below.
UAFG	**Modify**	**Modify**	We have accepted the AER's Draft Decision on the approach to setting forecast UAFG volumes, but propose the cost of replacement gas from renewable sources should be recovered as part of our opex allowance (rather than through the tariff variation mechanism) as these costs are largely known.
Debt raising costs	**Accept**	**Accept**	We have accepted the AER's Draft Decision and have not proposed any further changes.

Note: In this 'traffic light' table, green shading represents the acceptance, orange represents a modification and red shading represents a rejection

The following sections outline the reasons for our response to the AER's Draft Decision in this revised Final Plan.

1.4.1. Base year

We have updated our base year for actual costs reported in our Annual RIN submission. Our base year opex forecast post adjustments and including inflation for the 18 months to June 2021 is $58.8 million, which is $1 million above our forecast base year costs presented in our Final Plan and approved in the AER's Draft Decision. The increase is due to higher Administration & General and Network Development costs compared to forecast, partially offset by lower Operations & Maintenance costs compared to forecast.

Removal of non-recurrent costs and category specific forecasts

Our base year opex was adjusted by $5.6 million to remove movement in provisions, debt raising costs and UAFG costs. This is consistent with the adjustments in the AER's Draft Decision.

Accounting for changes to capitalisation of overheads

Consistent with our Final Plan, we have decided not to move any of our capitalised overheads to opex in the next AA period. While we did propose a change in our Draft Plan to include some of the capitalised overheads for 2019/20 in the base year opex, and we believe this proposal better aligns with accounting rules, making this change now (given the movement in other inputs since our Draft Plan) would result in a lower price cut than in our Draft and Final Plans. Therefore, we will revisit this for the subsequent AA period.

1.4.2. Trend

1.4.2.1. Input cost escalation

Labour cost escalation

For the revised Final Plan we have applied a real labour cost escalation averaging 0.5% per annum, which 0.6% higher than the -0.1% per annum in the AER's Draft Decision and consistent with the 0.5% per annum applied in our original Final Plan.

In the Draft Decision the AER forecasted labour price growth using only its consultant, Deloitte Access Economics' forecasts on account of the Deloitte Access Economics forecasts being the most recent forecasts available which also included the impact of COVID-19. The AER recognised this was a change to its previous standard approach of averaging the forecasts from Deloitte and the business' consultant (generally BIS Oxford Economics), however the AER stated it will consider updating the rate of change forecast using its standard approach provided the necessary forecasts are available.[31]

Consistent with the approach taken in our Final Plan and the AER's standard approach, we have continued to take the average of the WPI growth forecasts for SA provided by Deloitte Access Economics and BIS Oxford Economics.

In response to the AER's Draft Decision, we have revised our real labour cost escalation to reflect the inclusion of updated WPI forecasts for SA provided by BIS Oxford Economics. This forecast factors in the full economic impact of the COVID-19 pandemic as at December 2020. Therefore we consider the average of both utility WPI growth forecasts from Deloitte Access Economics and

[31] AER, Draft Decision, Attachment 6, p. 26.

BIS Oxford Economics reflects the best possible forecast of labour real price growth in the circumstances.

We note that in its Final Decision on SA Power Networks' access determination for the 2025-2026 period, the AER reverted back to its standard approach of using the average of both sets of utility WPI growth forecasts as it considered an average of Deloitte's and BIS Oxford Economics forecasts reflect the best estimate of labour price growth.[32] The AER considered, in principle the economic literature generally supports using an average of the available forecasts. It also referenced its findings on the Victorian distributors determinations, that an average of both Deloitte's and BIS Oxford Economics Victorian utility WPI growth forecasts has been more accurate over the 2007-2018 period.

Our forecast also factors in the impact of the proposed increases to the Superannuation Guarantee (SGC) increase of 0.5% per annum, which is in line with the AER's Draft Decision on the assumption that the SGC commences on 1 July 2021.

More detail can be found in BIS Oxford Economics' Report (Attachment 7.8A).

Table 1.5 shows our updated calculation of annual real labour cost escalation.

Table 1.5: Updated calculation of annual real labour cost escalation

Labour cost estimates	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
BIS Oxford	0.91%	0.64%	0.19%	0.33%	0.69%	0.74%
Deloitte Access Economics	0.39%	-0.92%	-1.10%	-0.81%	-0.31%	0.30%
Impact of SGC	-	0.50%	0.50%	0.50%	0.50%	0.50%
Average of BIS & DAE + Impact of SGC	**0.65%**	**0.36%**	**0.04%**	**0.26%**	**0.69%**	**1.02%**

Materials cost escalation

For our revised Final Plan, we have continued to apply zero real cost escalation per annum to our materials costs, consistent with our approach in our Draft and Final Plans, and also with recent regulatory decisions.

This was informed by BIS Oxford's review of forecast prices for gas network related materials. BIS Oxford concluded that some materials are forecast to achieve real price growth over the next period (including polyethylene pipe and concrete), while others are forecast to see negative (steel pipe) or no real price growth (general materials and gas and fuel construction price index).[33]

Weighting

We have continued to adopt the AER's input price weightings of 59.7% labour and 40.3% materials, consistent with our Final Plan and other recent AER decisions. This results in a weighted annual input cost escalation averaging 0.3% over the next AA period.

[32] AER, Final Decision on SA Power Networks distribution determination 2020-25, Attachment 6, pp. 13-17.
[33] BIS Oxford Economics, Input cost escalation forecasts to 2025/26, January 2021, p. 44.

Table 1.6 shows our updated calculation of annual input cost escalation which is a weighted average of the labour and materials cost escalation outlined above.

Table 1.6: Updated calculation of annual input cost escalation

Category	Weight	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Labour	59.7%	0.65%	0.36%	0.04%	0.26%	0.69%	1.02%
Materials	40.3%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%
Annual input cost escalation		**0.39%**	**0.22%**	**0.03%**	**0.16%**	**0.41%**	**0.61%**

1.4.2.2. Output growth

We have updated the output growth factor over the next AA period to reflect updates in forecast growth in customer numbers and kilometres of mains in the network. This results in an average output growth rate of 0.8% per annum over the next AA period, which is 0.1% lower than the rate applied in our Final Plan and approved by the AER in its Draft Decision.

This change is driven by:

- A small increase in growth in customer numbers compared to our Final Plan resulting from updated new connections forecasts for the next AA period (refer section 1.4.1 of Attachment 12.4 Our response on demand)); offset by
- A reduction in the growth in mains length compared to our Final Plan resulting from our decision not to extend our network to Mt Barker at this time.

More information on the updates to customer numbers and kilometres of mains can be found in Attachments 8.7A, 8.11, 12.1A, 12.2A and 12.4.

Table 1.7 shows the updated calculation of the output growth escalation factor.

Table 1.7: Updated calculation of the output growth escalation factor

Category	Weight	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Customer numbers	50.6%	0.93%	0.94%	1.26%	1.17%	1.22%	1.25%
Mains length km	49.4%	0.43%	0.54%	0.45%	0.42%	0.44%	0.45%
Annual input cost escalation		**0.68%**	**0.74%**	**0.85%**	**0.79%**	**0.82%**	**0.85%**

1.4.2.3. Productivity growth

We have accepted the AER's Draft Decision and continued to apply a productivity growth factor of 0.4% per annum over the next AA period, consistent with our Final Plan.

1.4.2.4. Trend rate of change

Based on the changes outlined above, we have applied a revised forecast average annual rate of change of 0.7% which is summarised in Table 1.8 below.

Table 1.8: Opex trend annual rate of change

	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26
Input prices	0.39%	0.22%	0.03%	0.16%	0.41%	0.61%
Output growth	0.68%	0.74%	0.85%	0.79%	0.82%	0.85%
Productivity growth	-	0.40%	0.40%	0.40%	0.40%	0.40%
Opex annual rate of change	**1.07%**	**0.55%**	**0.47%**	**0.54%**	**0.83%**	**1.05%**

1.4.3. Step Changes

We are proposing two step changes to opex totalling $4 million in the next AA period. These are:

- A Digital Customer Experience Project; and
- An incremental increase to our insurance premium.

In response to the AER's recommendations in its Draft Decision, we have incorporated our VCAP proposal as a category specific forecast rather than a step change. This is discussed at 1.4.4.2 below.

We do not consider the step changes we proposed will be appropriately compensated through the forecast rate of change, as suggested by the AER. This is because:

- Updated estimates of real input cost escalation in our trend are very low (0.1% per annum), with non-labour price growth continuing to be set at zero;
- A real input cost escalation reflects forecast changes in the cost of providing current (and not new) services;
- The output growth escalation factor provides for incremental increases in opex relating to additional customers and network length over the period, where our proposed step changes relate to an uplift in service levels for all customers and a hardening of the commercial insurance market (both of which are independent of the increase in the number of customers and length of mains in our network);
- We have already applied an ongoing productivity factor which reduces forecast opex on the expectation that we seek ongoing opex efficiencies; and
- We are already absorbing opex cost pressures of around $4 million which we did not pursue as a step change in our Final Plan, recognising that our customers prefer lower gas prices. The additional opex consists of:
  - increases in ongoing IT licencing costs following our ERP upgrade this year ($1.4 million);
  - our rationalisation of integration applications and establish data architecture, reporting and governance projects ($0.8 million); and
  - increasing opex related to uplifting our cyber security maturity ($1.4 million).

This means we would need to see around $8 million of reduced costs ($4 million in step changes not approved in the Draft Decision plus $4 million of cost pressures we proposed to absorb) related to cost increases lower than inflation over the period to be appropriately compensated through the forecast rate of change, if the proposed step changes are not approved. We also note in a review of our non-labour costs, we have not identified any non-labour inputs that will increase by less than CPI or will significantly decline at a rate to offset increases we have identified as step changes.

We consider that the proposed step changes should not be excluded on the basis that the AER views the step changes not to be material, or not sufficiently exceptional, that it would materially change total opex over time beyond what is captured through the price growth forecast. We also note that:

- Input cost escalation is in respect of those services currently supplied by the business;
- We are absorbing certain cost pressures in relation to those existing services; and
- We are applying an explicit productivity adjustment.

Further, we consider that when viewed on an aggregate basis (particularly taking into account the opex cost pressures we have absorbed outlined above), the step changes are sufficiently material that they are not captured through the price growth forecast. We also observe that the AER's general approach is to assess whether opex, in aggregate, is sufficient to satisfy the opex criteria over the AA period, rather than to assess individual opex projects or programs.[34]

1.4.3.1. Digital Customer Experience Project

Consistent with our Final Plan, we are proposing the Digital Customer Experience Project as a step change. The Digital Customer Experience Project proposes to materially increase the quality of services we provide to our customers through an uplift in digital and self-service capabilities in the following ways:

- CRM implementation – Allows us to deliver a materially improved customer experience by enabling us to capture, track and safely store customer information and respond to and update customers on enquiries and requests in a more proactive and timely manner.
- Website enhancement and upgrades – Materially improves customer experience through proposed website enhancements and upgrades to deliver new self-service capabilities and channels of communication. This will enable our customers to have more visibility, transparency and effective status communications for the touchpoints they have with us compared to the existing telephone and mail-based communications currently in place.
- Meter reading app development – Allowing our customers more personal control over their meter readings, increased visibility into their usage and allow them to engage with us at a time, place and channel that suits, alleviating potential property access issues due to missed communications.
- Automated SMS – Ensuring important events are communicated to our customers in a timely manner by replacing unreliable paper-based and manual communications. This will deliver a better-quality service to our customers, particularly to our life support customers for whom it is critical that our notifications of planned maintenance that will affect their gas services are effective.

As stated in the Final Plan, this project represents a new activity developed in response to feedback through our customer and stakeholder engagement program. This project is a distinct uplift in services, for all customers, rather than a refinement of our existing services and should be captured through additional opex rather than through the forecast rate of change which reflects

[34] AER, Draft Decision, Attachment 6, p. 12.

incremental costs associated with our existing cost base as the number of customers and length of mains in our network grows.

1.4.3.2. Increase in insurance premia

Our revised Final Plan continues to seek a step change on account of forecast increases to insurance premiums over and above the trend over the next AA period. Our insurance expenses are expected to increase well above inflation over most of the next AA period and the rate of change (to account for input cost escalation and output growth) will not be sufficient for us to recover our prudent and efficient costs.

The real non-labour price growth is set at zero, consistent with prior periods. This means the increase in insurance premiums allowed for in the Draft Decision forecast of opex is equal to CPI only. As discussed in Marsh's Report submitted as part of our Final Plan, the insurance market is currently in the "hard phase" for both the Property and Liability categories, with double digit increases for both categories over the previous 10 quarters.[35] Marsh anticipates the market will remain hard over the next AA period and we will continue to see increases in our premiums well above the CPI increases allowed for in the Draft Decision.

Change in commercial insurance premia is mostly driven by global market cycles

The change in commercial insurance premia is mostly driven by global insurance cycles and therefore is unlikely to correlate with CPI as a measurement of change in premiums each year.

The CPI basket of goods and services generally reflects those that are purchased by residential households for consumption and therefore does not capture the changes in commercial insurance premia. This is confirmed by reviewing the insurance item in CPI which covers domestic insurance items like comprehensive insurance for dwellings and motor vehicles, including compulsory third-party motor vehicle insurance services.[36]

Even if commercial and household insurance premia have similar drivers, the insurance and financial services category only represent a very small proportion of the basket of goods making up the CPI with the most recent annual re-weight resulting in 5.13% for the insurance and financial services category and the insurance component only representing 1.24%.[37] This suggests that the influence of the insurance item on the changes in CPI is minimal and therefore the rate of change in opex is unlikely to sufficiently compensate us for the increases we will experience in these costs over the next AA period.

Increase in insurance premia unlikely to be offset by other non-labour costs rising by less than CPI

In response to the AER's statement that "we expect some non-labour components in opex will increase by more than CPI and some less than CPI. To the extent that higher insurance premiums rise by more than CPI, we expect this will to an extent be offset by other non-labour costs rising by less than CPI"[38], we have conducted a review of our non-labour opex.

We have not identified any non-labour inputs that will increase less than CPI or will significantly decline at a rate to offset increases in our insurance premiums. Therefore, to the extent that insurance premia rise by more than CPI, we do not expect the increases will be offset by other non-labour costs rising by less than CPI. Further, we have outlined additional cost pressures for opex of around $4 million that we have already proposed to absorb. Therefore, it is unlikely the

[35] AGN Final Plan, Attachment 7.7, Marsh Insurance AA Report, July 2020.
[36] Based on ABS Household Expenditure Survey (HES); https://www.abs.gov.au/methodologies/guide-consumer-price-index-17th-series-methodology/2017
[37] ABS: https://www.abs.gov.au/statistics/research/2020-annual-re-weight-australian-consumer-price-index
[38] AER Draft Decision, Attachment 6, p. 36.

increase in insurance premia will be offset by other non-labour costs rising by less than CPI over the period.

1.4.4. Category specific forecasts

1.4.4.1. UAFG forecasts

We are forecasting $40 million in UAFG costs over the next AA period, an increase of $1.5 million (or 2%) compared to the AER's Draft Decision but a decrease of $7 million (or 16%) from our Final Plan.

We welcome the AER's Draft Decision to allow us to replace UAFG with renewable sources of gas, as long as the impact on bills falls within the $1.5 to $5.5 per annum range supported by our customers[39]. Our current proposal from our UAFG provider is for 150TJ per annum of our total UAFG is biomethane. As these costs are already reasonably known,[40] we consider it appropriate to factor this in our forecast opex (rather than recovering this through the annual tariff variation mechanism). This is the only difference in our proposal compared to the AER's Draft Decision.

We have reflected the AER's Draft Decision to adopt a two-year rather than three-year average of actual volumes to forecast the volume of UAFG over the next AA period. This, and slightly lower prices based on market prices for replacement gas (even when including some replacement gas from renewable sources), sees total UAFG costs $7 million lower than proposed in our Final Plan, and consistent with levels seen in the current AA period.

This is a great outcome for customers where we are able to directly reduce emissions and support continued affordability. We will also continue to explore potential additional sources of renewable gas whose price impact falls within the range deemed acceptable by our customers.

1.4.4.2. Vulnerable Customer Assistance Program

We maintain our Final Plan proposal on the VCAP in the next AA period. Our VCAP will:

- Provide a dedicated resource to run the program;
- Develop a priority services register using an upgraded CRM
- Provide funding:
  - for gas appliance safety checks and emergency appliances for our vulnerable customers; and
  - to help our vulnerable customers access more efficient appliances.

This is on top of the initiatives we have planned and are already underway to improve the way we support our vulnerable customers that will be funded through our existing opex base.

The VCAP proposal will enable a materially higher level of service to be delivered to our vulnerable customers. The VCAP initiatives will improve the customer experience for our vulnerable customers and will also reduce the financial barriers that some vulnerable customers may face in terms of utilising gas more efficiently and/or ensuring their appliances are operating in a safe and reliable manner. A summary of the service offering of our VCAP proposal is provided in Figure 1.1.

[39] For more detail on our stakeholder engagement program, refer to AGN SA Final Plan, Attachment 5.3, KPMG Customer Engagement Report, pp. 33-34

[40] We have provided the AER with a copy of the indicative gas sales agreement from our selected gas supplier as part of our response to AER Information Request IR019

Figure 1.1: Summary of new services under the VCAP proposal

Since the release of our Final Plan we have continued to engage with our customers and stakeholders on our VCAP proposal, including our Reference Groups and through submissions to the AER on our Final Plan. In particular we discussed:

- The relationship to other programs and whether there was a duplication;
- Program design, specifically whether we had the right mix of support services, it is cost-effective, fit for purpose and appropriate; and
- How the program could and should be funded.

Stakeholders agreed that there was no duplication in our proposed VCAP offering and support provided by other service providers. We did discuss that there would be some operational synergies and we will continue to work with other service providers such as retailers on the operational aspects of the program.

Stakeholders were supportive of the proposed support services and understood that there would be some learning over time as to the services that are needed and valued most once the program is underway. We will report on the progress and uptake of the program and continue to engage with stakeholders to refine and target the funding to where it is most needed and valued.

Stakeholders agreed this program could and should be funded by all customers based on their support of this through our customer engagement program.

In response to the AER's Draft Decision, we are proposing the VCAP as a category specific forecast rather than a step change and will be reporting on project delivery costs as part of our AGIG Annual Review process. More information on our VCAP proposal and further engagement undertaken can be found in Attachment 7.2A.

1.5. Summary

Our revised Final Plan opex forecast for the next AA period is $350 million, which is $21 million higher than the AER's Draft Decision. Our revised opex forecast incorporates feedback from our customers and stakeholders and reflects the AER's preferred approach wherever possible.

A summary of our revised opex forecast is provided in Table 1.9 below.

Table 1.9: Revised Final Plan opex forecast summary ($ million, 2020/21)

Cost	2021/22	2022/23	2023/24	2024/25	2025/26	Total
Base year opex forecast	58.8	58.8	58.8	58.8	58.8	294.1
Step changes	0.4	0.8	1.0	1.0	1.1	4.3
Change in capitalisation	-	-	-	-	-	-
Trend	1.0	1.2	1.6	2.1	2.7	8.5
UAFG	8.1	8.1	8.1	8.1	8.1	40.4
VCAP	0.9	0.7	0.7	0.7	0.7	3.9
Total opex forecast (ex debt raising costs)	**69.2**	**69.7**	**70.2**	**70.8**	**71.4**	**351.3**
Debt raising costs	0.9	0.9	0.9	0.9	0.9	4.4
Ancillary Reference Service	2.4	2.4	2.5	2.5	2.5	12.4
Total opex (inc DRC and ARS)	**72.5**	**73.0**	**73.5**	**74.1**	**74.9**	**368.1**