3rd February 2016

Mr Warwick Anderson
General Manager
Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

By email to: AGN2015GAAR@aer.gov.au

Dear Mr Anderson,

Re: AER's Draft Decision on Australian Gas Networks (SA) Access Arrangement

Thank you for the opportunity to make this submission to the Australian Energy Regulator (AER) regarding its draft decision of 26th November 2015 and AGN's revised proposal of 6th January 2016 for the Access Arrangement for Australian Gas Networks (SA).

Overall Impact on Network Tariffs

ATA notes the combination of draft decisions that result in network tariffs down by 22.8% initially, then climbing 0.77% annually in real terms[1] (page 23).

The AER's draft decision reduced allowed CAPEX by 44% on AGN's proposal with the key difference scaling back the mains replacement program. As we noted in our original submission this CAPEX proposal failed to receive overwhelming customer support. Accordingly ATA welcomes this aspect of the draft decision. However, ATA notes the AER's allowed CAPEX is still $393.0 million (p17), which is high in historical terms, only lower than the last three years (p39).

Moreover the draft decision left the door ajar to adjust CAPEX back up, with AER noting on page 41 "Our draft decision also provides AGN with direction where we need more compelling evidence if its proposal is to be accepted." We note that in AGN's revised proposal of 6th January, they have taken up this opportunity. The CEO described the reduced mains replacement program as "an unacceptable safety risk"[2]. As our original submission stated, the AER should scrutinise the CAPEX safety proposals for evidence of informed understanding by consumers about level of risk or consideration of tradeoffs.

We note the required rate of return is the major contested issue. AGN's revised proposal of 6th January 2016 boosts the proposed rate of return to 8.2%, up from 7.23% in AGN's original proposal[3]. The AER's draft decision was 6.02% and ATA expects that the lower WACC will be the final decision of the AER. ATA also wishes to underscore that AGN's continuing shareholders and bondholders should have always made past investments with an understanding of all the risks (e.g. declining demand from a more efficient competitor being electricity and carbon constraints).

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[1] AER, Draft Decision- Australian Gas Networks Access Arrangement 2016 to 2021 Overview, November 2015.
[2] AGN, 'Arrangement Information, For Australian Gas Networks' South Australian Natural Gas Distribution Network', January 2016, page i.
[3] ibid

Official Residential Gas Demand Forecasts – Historic Trend Based

ATA thanks the AER for referring our submission, among others, to ACIL Allen for review and their independent advice in the context of assessing Core Energy's forecasts of gas demand.

ACIL Allen finished their summary of our submission with "Apart from arguing in general terms that gas demand will decline "because of a more efficient/cost effective competitor" it does not offer any specific critique of the Core demand forecasts or the methodology by which the forecasts have been prepared.[4]" (page 48).

At issue is the extrapolation of historical trends to gas demand. To be clear, forecasting is not objective science. Subjectivity comes in the choice of a time period (for example last 3, 5 or 10 years) and choice of method for extrapolation (for example, linear or exponential).

Another subjective choice is whether to forecast underlying demand then build up the impact of differing market drivers, which requires disaggregating those forces from the observed historical data series. These are some of the subjective choices to be made about forecasting methodology.

ACIL Allen says on page 37 that it "recognises that forecasting on the basis of extrapolation of historical trends involves a risk of overlooking changes in market drivers that could result in future trends differing from historical trends." These issues are well understood, even if the techniques for addressing them are underdeveloped.

ATA welcomes the AEMO's National Gas Forecasting Report published in December 2015, although it too relies on "backwards looking" forecasts for residential forecasts of gas demand. This report advances the sector's understanding of the impact of different factors at play reducing gas demand per connection.

These factors include energy efficiency improvements, drought (impacting on water consumption and hot water demand) and the Global Financial Crisis (which led to the home roof insulation scheme). AEMO continues to apply historical trends to connection rates.

Demand forecasts are required to be reasonable. ATA's submission in August 2015 suggested that consultants should have to justify their gas demand forecasts with reference to the economics of the appliance choices facing households, including different fuelled technologies. Core Energy failed to do this.

Based on our research, reasonable questions of a "trends based" forecasting approach would be:

- How many households would be newly connecting when it is an uneconomic choice for them?
- Why would households do this?
- What is the assumed or implied long-run market share of more cost effective technologies (e.g. efficient electric) and what take-up rate is implied?
- What proportion of forecast gas demand could be attributed to market failures[5]? (What is the downside risk to forecasts if governments choose to redress market failures, for example in response to the Paris Agreement to limit global warming to 2 degrees since the pre-industrial era?)

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[4] ACIL Allen Consulting, Report to the Australian Energy Regulator - Review of Demand Forecasts for the AGN South Australia Gas Networks for the Access Arrangement period commencing 1 July 2016 – Public Version, 11 November 2015, page 48.

[5] Market failures, include:

- Information barriers – it is difficult for a reasonably informed citizen to access reliable information about comparative running costs and ownership costs of appliances of different fuels. People tend to make decisions based on advice from friends and family and received wisdom says that mains gas is a cheap fuel source.

ACIL Allen argued historical trends of gas demand do include changing technology developments and that fuel substitution is accounted for with cross-price elasticity (page 49). In relation to the latter point, earlier (on page 33) they had said there are "significant practical and theoretical difficulties in establishing reliable estimates of cross-price elasticity" and the evidence of its level in Australia was "scant". We agree with this assessment.

ATA maintains that history is not the best guide to future residential gas connections and gas demand. ATA's submission argued that this practice, which contributes to the AER's draft decision, is not consistent with the planned and equitable contraction of the gas network that is likely to be required.

In addition, ATA is concerned about the proposed expansion of the network to Mt Barker that appears to have gained the conditional support of the SA Government. The ATA's work has demonstrated that continued expansion of the gas network is not in the long term interest of energy consumers and risks accelerating the gas death spiral.

As we said in our original submission, the ATA strongly advocates that businesses intending to expand gas networks into new housing developments are subject to a Regulatory Investment Test, as electricity networks are for asset replacement - to ensure the development is indeed in the long term interests of consumers. As part of this process, the suite of technology and fuel choice options available to consumers must be considered.

Thank you for the opportunity to submit to this process and should you have any queries, please do not hesitate to contact either Kate Leslie on kate.leslie@ ata.org.au or myself on 03 9639 1500.

Yours sincerely

Damien Moyse
Policy & Research Manager

- Split incentives - landlord/tenant. With the structure of the Australian tenancy system, tenants do not have any control over appliances in the house. The tight rental markets limits the scope for prospective tenants to choose housing based on energy running costs, even if that information was available. Furthermore the short term leases that characterise much of the Australian rental market reduce tenant's time horizons. Whereas homeowners may rationally choose to replace a gas space heater with reverse cycle air conditioners if the expected cost savings were within 5 years, tenants would not.
- Split incentives- builder/owner. If builders building 'on spec', without specific buyers in mind, they may be motivated to put the cheapest appliances into a residential building - gas.
- Split incentives - plumber/owner. When it comes to hot water, plumbers are more familiar with gas appliances. It might be easier for them to recommend those products (gas) with which they are most familiar.

These market failures are described and documented further in the context of heat pump hot waters in Commonwealth of Australia (2013), Equipment Energy Efficiency E3, Consultation Regulation Impact Statement: Heat Pump Water Heaters, July 2013. Page 10