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BusinessSA
South Australia's Chamber of Commerce and Industry

29 January 2016

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

Dear Mr Anderson

I write in response to the AER's draft decision on Australian Gas Networks (AGN) 2016-21 Access Arrangement (AA) and AGN's subsequent revised proposal.

Executive Summary

- In light of rapid growth in gas distribution costs between 2011 and 2015, all necessary steps must be taken to contain AGN's revenues over the 2016-21 AA period, starting with rate of return which should not be higher than the AER's draft determination of 6.02%
- We accept that AGN needs to continue its mains replacement program to meet safety requirements, but the $158.3 million increase proposed above the AER's draft decision amount is significant and there must be a high degree of assurance that it is all required over the 2016-21 AA period.
- The impact of AGN's proposed capital expenditure program is most obvious in the rising value of its regulatory asset base (RAB), from $1.02 billion in 2011/12 to $1.98 billion in 2020/21, at odds with forecast declining demand for the gas it delivers and connection growth of just over 1% per annum.
- The AER has not sufficiently justified its allowance of above CPI labour cost increases to AGN over the 2016-21 AA period, beginning with 0.45% in year 1 and rising to 1.88% by year 5, which we acknowledge is out of step with the commercial realties of South Australia's economy.

Should you require any further information or have questions, please contact Andrew McKenna, Senior Policy Adviser, on (08) 8300 0000 or andrewm@business-sa.com

Yours sincerely,

Nigel McBride
Chief Executive Officer.

Why this matter is important to South Australian businesses

As South Australia's Chamber of Commerce and Industry, Business SA is the peak business membership organisation in the State. Our members are affected by this matter in the following ways:

- South Australian businesses already pay the highest combined utility costs in the country and gas is a critical source of energy for many industries, particularly large employers in the manufacturing sector but also many small businesses such as restaurants, bakeries and take-aways.
- Business SA has been a member of AGN's customer reference group since 2014 to ensure the voice of business, particularly small business, is front and centre during any deliberations on spending which is ultimately passed back to business consumers.
- SA's economy only grew by 0.1% in the September quarter 2015, following 0.1% growth in the June quarter requiring all businesses to focus on reducing costs to counter weak demand; likewise, what businesses expect of AGN.
- Decisions on labour cost increases by the AER on AGN have wider ramifications for enterprise bargaining agreements in other industries making it critical that they are appropriately justified.

Key Policy Points

1. For commercial consumers, the distribution component of retail gas prices has increased from $9.48/GJ in 2011 to $14.68/GJ in 2015[1], an increase of 54.9% in just four years in contrast with constant transmission costs. Considering the distribution component of the average commercial gas bill is 55%, South Australian businesses cannot continue to absorb increases of this magnitude.

2. Business SA would like to reiterate that the AER's draft decision advises there are no regulatory or legislative obligations that require AGN to replace mains at the rate it has proposed over the 2016-21 AA period. In this case, consumers including business should be able to rely on existing regulators such as the AER and State based Office of the Technical Regulator to ensure that our gas distribution system remains safe. If this is not the case, the AER needs to clearly articulate regulatory gaps within the existing system which would justify allowing AGN to roll out a mains replacement program in excess of regulatory requirements even if it is predicated on the basis of safety.

[1] Core Energy Group, Gas Demand Forecasts – Attachment 14.1 (AGN 2016-21 AA), June 2015

2. In our previous submission to this consultation process, we outlined various concerns about the methodology used by external consultants to justify above CPI labour cost increases for AGN, particularly BIS Shrapnel. Our concerns were based on the fact that major projects such as the Olympic Dam expansion were used to justify future labour cost growth despite such projects being at best several years from becoming reality.

The AER has not addressed these concerns and has actually relied on an average which includes the BIS Shrapnel forecasts. Business SA expects that our concerns will be appropriately addressed in the final decision and that AGN's allowable labour costs will reflect the actual rates it should be able to achieve in the current economy.

Furthermore, the AER's decision on broadly allowing AGN real labour cost increases is at odds with their analysis of AGN's forecast approach for new estate connections which states:

We are satisfied with some aspects of the forecast approach, namely the competitively tendered processes that have resulted in the unit rates for mains, services and meters. However, we do not consider that applying construction and labour escalation to the contractor labour component of these unit rates would result in estimates that are arrived at on a reasonable basis. We note that the underlying contracts do not provide for any real construction, labour or material escalation.

3. Business SA acknowledges the AER for addressing stakeholder concerns about AGN's proposed incentives programs and acknowledges AGN for on the whole accepting the AER's rationale. Considering AGN's own messaging about gas being a fuel of choice, this should be incentive enough to ensure it pursues cost saving capital expenditure projects.

4. Business SA is encouraged that AGN was able to find material savings through its Business Intelligence Project which allowed it to absorb eight step changes totalling $8.3 million; originally requested in its operating expenditure proposal.

5. Business SA supports the AER's approach to transitioning AGN to a ten year trailing average cost of debt in line with other similarly regulated companies. We are now experiencing a record low interest rate environment and moving AGN directly to a ten year trailing average cost of debt would only provide them a windfall gain at the expense of consumers. The years leading up to and including the global financial crisis were characterised by an extraordinary level of risk in global financial markets which exhibited itself through high interest rates. Considering the broad consensus amongst economists on future interest rate rises, it would seem unlikely that AGN's future debt servicing costs are going to rise materially in the short to medium term and accordingly, they should be able to manage within the parameters set out in the AER's draft decision.

6. From AGN's revised proposal, Business SA notes that forecast residential connections are set to increase by 5.2% over five years while commercial connections are likely to rise by 6.7% over the same period. Concurrently, total residential demand is forecast to fall by 9% and commercial demand by 2.2%.

During the same period, the value of AGN's regulatory asset base is forecast to increase from $1.4 billion now to $1.98 billion by 2020/21, an increase of 41.4%. This is in addition to the increase in the RAB during the current regulatory period which has seen it increase 37.25% from $1.02 billion in 2011/12 to $1.4 billion in 2015/16. Business SA reminds the AER that its decision must be in the long term interests of consumers. Considering the returns on AGN's assets drive the majority of its revenues, the value of its RAB will be the predominant driver of long term gas prices, which will only be exacerbated if interest rates return to long term historical averages.

Additional information: Please see the following link to Business SA's previous submission to the consultation process on AGN's 2016-21 AA:

http://business-sa.com/assets/policy%20documents/150810_FINAL_submission%20on%20AGN%20access%20agreement%202016-21.2.pdf