BUSINESS SA Submission to AER on proposed

Australian Gas Networks Access Arrangement (2016-21)

August 2015

BusinessSA
South Australia's Chamber of Commerce and Industry

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Introduction

As South Australia's peak Chamber of Commerce and Industry, Business SA is South Australia's leading business membership organisation. We represent thousands of businesses through direct membership and affiliated industry associations. These businesses come from all industry sectors, ranging in size from micro-business to multi-national companies. Business SA advocates on behalf of business to propose legislative, regulatory and policy reforms and programs for sustainable economic growth in South Australia.

Business SA's analysis of AGN's proposed 2016-21 Access Arrangement (AA) is based on nominal dollars. Businesses are only concerned with the actual price impact of distribution costs and accordingly, while we recognise 'real' impacts, the nominal dollar hits the bottom line and that should be the benchmark for how the AA meets the requirements of the National Gas Law.

Should you require any further information or have any questions, please contact Rick Cairney, Director of Policy, Business SA on (08) 8300 0000 or rickc@business-sa.com.

Executive Summary

Currently, the South Australian economy is facing major 'headwinds' and the need to lower the cost of business has never been more critical. 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. The effective doubling of long term wholesale gas contracts in recent years has already hit business hard and while distribution cost rises are less visible, the average 54.9% increase in the distribution component of commercial retail prices over the past four years[1] has further compounded wholesale gas price rises.

Business SA recognises that AGN's proposed 2016-21 AA does provide some initial price relief for consumers but this soon dissipates over years 2 to 5 of the 2016-21 AA period. Notwithstanding what is proposed, South Australian businesses expect substantial and ongoing price relief, particularly in light of the significantly lower interest rates now available to finance AGN's gas distribution network. Furthermore, declining connection growth and consumption should be restraining future growth in the regulatory asset base, not increasing its existing value by approximately 50% over the 2016-21 AA period. Businesses are also generally satisfied with the level of reliability provided by AGN and are unwilling to spend more to enable AGN to improve it.

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

AGN has made a solid start to engaging stakeholders as part of the regulatory process pertaining to its 2016-21 AA, but business needs to see more savings passed back to consumers than what is currently proposed. The timing of AGN's proposed capital expenditure program is questionable against the backdrop of falling connection growth and declining consumption. It is also unclear as to how the current or 2016-21 AA period capital expenditure delivers material operating expenditure savings which should be the litmus test for the AER to approve such spending.

Business SA is not in support of either amending or introducing new incentive programs to encourage AGN to drive efficiencies, improve customer service or innovate within its business. AGN's business model, akin to South Australian businesses operating in a competitive market, should hinge on constantly striving to realise efficiencies and lifting customer service levels to ensure its business continues to grow. Natural gas is a 'fuel of choice' and South Australian businesses can no longer afford to absorb unjustifiably high gas distribution costs in addition to the rising wholesale price of gas.

Stakeholder Engagement

Business SA has been a member of AGN's customer reference group since 2014 and has found AGN's approach to stakeholder engagement to be quite genuine and well intended. Notwithstanding the interests of stakeholders and AGN will not always align, Business SA has been able to work constructively with AGN and we wish to acknowledge their professional approach to dealing with stakeholders.

Reliability and Price in South Australia's Gas Distribution System

It is very important that South Australian businesses continue to have access to a reliable supply of gas through AGN's distribution network. Despite the recent failure of Epic Energy's Moomba pipe supplying Port Pirie and Whyalla, which we acknowledge was outside AGN's control, issues of gas reliability in South Australia are minimal and business is generally satisfied with the level of supply. In a survey of members conducted in March 2014, Business SA found that 94.6% of respondents were satisfied with the level of gas reliability delivered by Envestra (now AGN).

Business SA acknowledges the official low rate of major disruptions to South Australia's gas supply which is an important factor in providing continuity for business. South Australia's manufacturing sector, a large user of gas for industrial processes and feedstock, is facing significant challenges with the pending closure of local auto-manufacturing. Consequently, a reliable and affordable supply of gas is critical to not only retain existing manufacturing, but is also essential to develop new manufacturing industries.

While reliability is important, the cost of gas is equally critical to ensuring manufacturing in South Australia is viable. Gas consumers, particularly large industrial users on long term contracts, have already had to contend with substantial gas price rises in recent years, predominantly driven by the wholesale price of gas increasing from approximately $4.50/GJ to $8.50/GJ. Business SA recognises that LNG export demand is a major factor driving the increase in gas prices, but gas distribution costs still account for 55% of the total average commercial gas bill and AGN's ability to control gas price rises for business is significant.

Business SA refers to Core Energy Group's historical gas price information which shows that for commercial consumers, the distribution component of retail gas prices has increased from $9.48/GJ in 2011 to $14.68/GJ in 2015[2], an increase of 54.9% in just four years in contrast with constant transmission costs. South Australian businesses cannot absorb increases of this magnitude and all necessary steps must be taken to reign in network spending in the 2016-21 AA period.

Capital Expenditure

Business SA recognises that AGN must continue to upgrade the distribution network in order to preserve existing levels of reliability. The program to replace the final 752 km of unprotected steel and cast iron mains is forecast to be completed in the 2016-21 AA period while the new driver of future capital expenditure will be the 312km targeted replacement of the high density polyethylene (HDPE) network, also scheduled from 2016-21.

Notwithstanding the need to ensure reliability, Business SA is concerned about the level of increase in capital expenditure which is forecast to rise from $478.6 million in the current 2011-15 AA period to $762.7 million over the 2016-21 AA period. This represents a 59.4% increase over five years, or approximately 12% per annum. This is against the background of declining total consumption, consumption per connection and connection growth. In fact, according to AGN, residential connection numbers have historically been growing at 1.8% per annum but have slowed since 2011 and for 2013/14 dropped to only 1.4%. Over the 2016-21 AA, residential connection numbers are forecast to grow at only 1.2 to 1.3% per annum while commercial connection numbers are forecast to grow at 1.3 to 1.7% per annum. Concurrently, total consumption is forecast to decline by approximately 2% per annum and weather normalised consumption per residential and commercial connection is forecast to decline by 4% and 1.8% per annum respectively.

Based on AGN's Mains Replacement Plan, there appears to have been a substantial amount of work undertaken to determine the risks associated with each type of mains replacement. Business SA acknowledges the APA Group's advice to AGN to replace sections of the Class 575 HDPE network where a combination of past failures, location, operating pressure, soil type and housing construction present an unacceptable public risk.

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

In relation to the Class 250 HDPE network, which we recognise is older, the APA Group's advice is that brittle failures of Class 250 HDPE mains are expected to increase over the next 5 – 10 years to the extent that a risk reduction program is necessary. At face value, this advice does not necessitate all medium pressure Class 250 HDPE mains being replaced by 2021 and we recommend the AER investigate further as to whether an extended timeline for replacing these mains is more prudent.

Business SA acknowledges the safety risks associated with ageing cast iron mains but considering the APA group's comments that "this plan prioritises replacement of mains that are assessed as posing the highest risk,"[3] we question whether replacing the entire cast iron and unprotected steel network necessarily needs to be completed in the next AA period.

Business SA commends AGN for looking at alternative risk assessment technologies such as pipe cameras to more accurately assess necessary capital expenditure. However, the reality is that AGN is requesting a significant step increase in capital expenditure over the 2016-21 AA and given the need to contain future gas price rises as the South Australian economy contends with a major structural adjustment post Holden, any non-essential expenditure should be deferred.

Information Technology (IT) related capital expenditure is another area of concern in AGN's proposal. Over the current AA period, AGN have already spent approximately double the AER allowed benchmark amount on IT related capital expenditure. Notwithstanding whether or not the requirements or complexity of the new Enterprise Asset Management (EAM) system were known at the time the benchmark was set, this additional $12 million is still subject to recovery from South Australian consumers. Consequently, Business SA is quite cautious in supporting further major IT related capital expenditure without demonstrable savings to consumers.

Over the 2016-21 AA period, AGN is proposing a substantial investment in the continuation of its national program of work to replace outdated and obsolete state-based IT systems with enterprise equivalents servicing all five Australian jurisdictions in which AGN operates. This expenditure may well improve AGN's operational efficiency across Australia but it is not clear as to why South Australian consumers in particular should 'foot' the whole bill?

The total proposed increase in IT related capital expenditure from $24.0 million in the existing AA period to $59.7 million over the 2016-21 AA period represents a 248% step change. In a period of both declining consumption and slowing connection rates, Business SA does not support such levels of increasing expenditure without seeing clear evidence of the tangible savings which will accrue to consumers.

[3] APA Group / Australian Gas Networks, Mains Replacement Plan, June 2015

Operating Expenditure

Business SA recognises that AGN's operating expenditure over the current AA period is approximately $32 million (or 9%) below the AER allowable benchmark. AGN advises this outcome is a result of strict cost management practices in response to the AER Efficiency Benefit Sharing Scheme (EBSS) and economies of scale realised through its contractor, the APA Group, being the largest owner/operator of natural gas infrastructure in Australia.

AGN's actual operating expenditure over the current AA period is estimated at $339 million and is only forecast to increase to $352.7 million over the 2016-21 AA period. While at face value the small increase in operating expenditure is promising, there does not appear to be any substantial savings being realised through the 59.4% step change in capital expenditure. For one, replacing a substantial part of AGN's mains network should result in significantly less gas leaks to respond to but such savings are not apparent. In fact, AGN states that "UAFG volumes have fallen by 34% over the current AA period, largely as a result of our mains replacement program."[4]

Business SA disagrees with any evidence to suggest AGN can justify labour costs being subject to real cost escalation in the 2016-21 AA period. At present, there is significant wage restraint in the South Australian economy on the back of weak business conditions and high unemployment. At a public sector level, there are wage rise caps are in place similar to those imposed nationally. Historic wage outcomes for utility workers will not hold over the next few years considering South Australia already has the nation's highest unemployment rate at 7.9%[5] which is only likely to worsen as the economy adjusts to the loss of auto-manufacturing in 2017.

The South Australian economy continues to stagnate, with Gross State Product growing at just 1.3% during 2013/14[6]. The latest State Final Demand figures for the nine months to March 2015 also indicate flat economic growth for 2014/15, increasing 1.5% year on year and with exports down 8.2% year on year to June 2015[7], the final Gross State Product figure for 2014/15 likely to be even less. Beyond that, Gross State Product is forecast to grow at just 2.0% from 2015/16 to 2017/18.[8]

[4] AGN, 2016-21 Access Arrangement, P 115
[5] ABS, Labour Force figures, August 2015
[6] ABS, Australian National Accounts 2013/14, 21 November 2014
[7] ABS, International Trade in Goods & Services, July 2015
[8] South Australian Government, 2015/16 Budget, June 2015

Furthermore, Business SA's June Quarter 2015 Survey of Business Expectations found a majority of businesses (67.1%) expect the South Australian economy to weaken over the next 12 months, compared with 25.7% forecasting stability and only 7.1% expecting growth. AGN has also recognised South Australia's weak economy stating "the key reason for the negative variance between actual and benchmark volumes in the commercial customer segment is the relatively weak economic conditions experienced in South Australia."[9]

AGN's forecast real labour cost increases are based on a January 2015 report by BIS Shrapnel which is now somewhat outdated. In this report BIS Shrapnel states that 'The state's outlook depends quite heavily on how industry responds to a weaker dollar; there are very few other growth drivers to speak of. The $2 billion Carrapateena copper project (scheduled to begin in 2016/17) and the Olympic Dam expansion (scheduled to begin in 2018/19) should provide a boost, but there is a dearth of other major projects on the horizon.'[10]

We are surprised that BIS Shrapnel have given weight to the Olympic Dam expansion project considering BHP shelved its major expansion plans in 2012 and have subsequently given only quite conservative forecasts about the nature of any future expansion. Additionally, yesterday BHP announced a further 380 jobs were to be cut at Olympic Dam.

Furthermore, the Carrapateena copper-gold project is only at a pre-feasibility stage so should not be relied upon to inform economic modelling forecasts, particularly those for a regulated entity.

Business SA also notes that AGN's total employee and contractor numbers have increased from 434 in 2011 to 648 in 2014, and increase of 49.3%. Although we acknowledge the cast iron and unprotected steel mains replacement program would involve additional labour, it is unclear as to exactly what has driven this substantial increase in its entirety and we suggest the AER request further detail from AGN.

Incentive Schemes

Business SA acknowledges the established efficiency benefit sharing schemes (EBSS) in place for regulated utility providers in the electricity and gas sectors. However, while there are grounds to incentivise utility companies to work harder to deliver savings to consumers, they need to be in the context of broader returns to the company owners. Furthermore, they need to ensure that where there is already likely to be future savings that incentives are not paid to encourage such savings. For example, in a period of increasing capital expenditure, which already gets capitalised into the regulatory asset base, logic suggests subsequent savings in operating expenditure should not subject to incentive payments.

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[9] AGN, 2016-21 Access Arrangement, P80
[10] BIS Shrapnel, REAL LABOUR COST ESCALATION FORECASTS TO 2019/20 – AUSTRALIA AND SOUTH AUSTRALIA, January 2015

In relation to AGN's proposed restructure of benefits from the existing 70% to consumers / 30% to the utility provider, to schemes which evenly split benefits between both parties; this represents a significant movement away from existing AER practice and established incentive schemes across the regulated utility industry and we see no grounds to support such change.

In considering AGN's proposed customer service incentive scheme, we note that during the current AA period, 90% of emergency calls have been answered within 10 seconds. Furthermore, AGN advises there have only been, on average, 15 major network interruptions (which affect more than five customers) per year and their System Interruption Duration Index (SAIDI) performance has improved over the past four years, and is consistent with good industry practice.[11] Deloitte's Stakeholder Insights Report also reports that stakeholders are generally satisfied with AGN's customer service and reliability levels. [12]

From a business perspective, we have no issue with the level of customer service AGN is delivering and do not see how a new stand alone incentive scheme is justified. Recognising that gas is a "fuel of choice", improving customer service is necessary to not only maintain, but to grow AGN's existing customer base. Accordingly, there is no requirement for an additional incentive scheme specifically targeted at improving customer service to reward AGN for improving what is already a fundamental business imperative.

While we acknowledge that 60% of participants at stakeholder workshops were in favour of a guaranteed service level (GSL) scheme for gas in South Australia and that AGN's proposed customer service incentive scheme is in lieu of this, there is still no requirement for the AER to incentivise AGN to improve its level of customer service.

In relation to AGN's proposed network innovation incentive scheme, all businesses in a market economy need to continue innovating to remain profitable as they compete for market share, often against international companies whose innovation continually drives down their per unit production costs. While Business SA recognises AGN has a natural monopoly over gas distribution in South Australia, it should still be subject to shadow market forces which apply in the broader competitive market economy. A range of Government incentive schemes to fund innovation already exist, most notably the research and development tax incentive, and Business SA does not support the need for a separate scheme to apply to AGN's 2016-21 AA.

[11] AGN, 2016-21 Access Arrangement, P88
[12] AGN, 2016-21 Access Arrangement, P55

Rate of Return and the Regulatory Asset Base

Business SA acknowledges AGN's proposed rate of return of 7.23% for the 2016-21 AA period which is substantially above the AER's June 2015 decision of 5.41% for New South Wales' largest gas distribution network owned by Jemena. Business SA supports the AER's existing decision on Jemena and is not convinced by any evidence presented to the contrary that the rate for AGN should be materially different. The AER has acted within its non-binding rate of return guideline which was formulated through consultation with stakeholders and its decision should stand. Notwithstanding, we recognise the AER's Jemena decision is currently subject to appeal and the Australian Competition Tribunal's ruling is likely to have a direct influence over the ultimate outcome of AGN's rate of return.

Aside from direct issues relating to rate of return, the growth of AGN's regulatory asset base in the current AA period has seen it increase from $1,020 million in July 2011 to a forecast $1,428.8 million in 2015/16, an increase of 40% over five years or 8% per annum. Furthermore, in its 2016-21 AA, AGN forecasts its regulatory asset base to increase further to $2,116 million by the end of 2020/21, an increase of 48.1% in 5 years. Combined, if the AER accepts AGN's proposal, the value of its regulatory asset base will have increased by over 200% in just 10 years against a backdrop of declining connection growth and consumption. In fact, according to AGN, residential consumption per connection has fallen approximately 30% in the past 15 years[13] while commercial consumption per connection has fallen approximately 25% over the same period.[14]

The growth in the regulatory asset base puts any argument about rate of return in perspective and Business SA is very concerned that when interest rates return to normal levels, the revenue recovered from consumers to provide a regulated rate of return to AGN will rise substantially. As representatives of business, we are not just concerned about outcomes for members in this period, but what impact AER decisions made in this period have on the cost of gas distribution in subsequent periods.

[13] AGN, 2016-21 Access Arrangement, P231
[14] AGN, 2016-21 Access Arrangement, P239