Advice to AER from Consumer Challenge Panel sub-panel 8 regarding the AER Draft Decision and Australian Gas Networks' (SA) Revised Access Arrangement 2016-2021 Proposal

31 March 2016

1. Introduction

On 1 July 2015, Australian Gas Networks (AGN) submitted a gas access arrangement proposal (AAP) for its South Australian distribution network to the Australian Energy Regulator (AER) for the period 1 July 2016 to 30 June 2021, pursuant to its obligations under rule 52 of the National Gas Rules (NGR).[1] Consumer Challenge Panel sub-panel 8 (CCP8) provided advice to the AER regarding AGN's initial Access Arrangement 2016-21 Proposal (AAP) on 25 August 2015.[2]

On 26 November 2015, the AER released its Draft Decision (DD) on AGN's AAP.[3]

AGN submitted its Revised Access Arrangement 2016-21 Proposal (RAAP) on 6 January 2016.[4]

The purpose of this document is to provide further advice to the AER regarding both its Draft Decision (DD), and AGN's Revised Access Arrangement 2016-21 Proposal (RAAP).

2. CCP8 Overview of Key Issues in the AER's Regulatory Process to Determine AGN's 2016-21 Access Arrangement

The following table summarises CCP8's view of the key elements and the major differences between AGN and the AER to date.

	AGN AAP	AER DD	AGN RAAP
Total Revenue	$1148m	$939m	$1226m
Rate of Return	7.2%	6.0%	8.2%
Operating Expenditure	$353m	$342m	$359m
Capital Expenditure	$699m	$393m	$637m
Incentive Schemes	Modified EBSS + 3 new schemes (CESS, NIS, CSIS)	Retain EBSS unchanged, no new schemes	Re-proposing CESS
Tariff Price Path (in real terms)	11% decrease in 2016-17, increases of 5% pa for remaining 4 years	22.8% decrease in 2016-17, increases of 0.8% pa for remaining 4 years	5.5% decrease in 2016-17, increases of 5% pa for remaining 4 years

Source: CCP8 analysis of AER DD, AGN RAAP

Note: EBSS – Efficiency Benefit Sharing Scheme; CESS – Capital Efficiency Sharing Scheme; NIS – Network Innovation Scheme; CSIS – Customer Service Incentive Scheme

In our earlier advice, we stated that "we consider that price reductions beyond the modest level proposed by AGN are both necessary and achievable over the next regulatory period". Consistent with that, we endorse many aspects of the AER DD. In particular, we support:

[1] https://www.aer.gov.au/node/33310
[2] https://www.aer.gov.au/node/33313
[3] https://www.aer.gov.au/node/33379
[4] https://www.aer.gov.au/node/33380

- Adherence to the AER's Rate of Return Guideline, and the nominated 6.0% overall rate of return. This is clearly the major influence on the proposed lower tariffs for consumers in the AER DD.
- A significant reduction in the capital expenditure forecast. This has the effect of moderating the concerning growth in AGN's regulated asset base which is the driver for higher prices in future regulatory periods.
- Lower operating cost allowances based on the elimination of a number of proposed step changes from the operating expenditure forecasts.
- Retaining the existing allocation of any efficiency benefits accruing from the EBSS.
- Revision of demand forecasts.

We note and commend the approach taken by AGN in the preparation of its RAAP "to accept as many other aspects of the AER Draft Decision as possible, including where we might not necessarily agree with the AER's approach but where 'in the round' we believe we have a reasonable opportunity to recover our efficient costs."[5]

Nevertheless, we continue to have residual concerns regarding aspects of both the AER's DD and AGN's RAAP, and these are explained in the remaining sections of this report.

3. Rate of Return

The AER's 2015 decisions on rate of return for the NSW and ACT electricity distribution networks were recently a matter for consideration by the Australian Competition Tribunal. The Tribunal's determinations on rate of return will also be relevant for AGN.

The AGN RAAP proposes a rate of return or Weighted Average Cost of Capital (WACC) of 8.2%. This is a significant departure from the WACC of 7.2% submitted in the AAP which, if implemented, would have a very large impact on consumers. AGN has not provided any justification for this increase, apart from the statement that it is "to cover all possible outcomes from the Tribunal".[6]

Absent any justification based on changes in AGN's business environment since 1 July 2015, and the fact that a WACC of 7.2% was considered sufficient at that time, the proposed change to WACC presents as an opportunistic attempt to gain windfall profits at the expense of AGN's consumers. In contrast, at least one other network business operating in a comparable business environment and submitting a regulatory proposal to the AER in the same timeframe considers that a value of WACC around 6% is acceptable.[7] We advise the AER to reject the WACC proposal in AGN's RAAP.

It is also of concern that such a major change to AGN's AAP should be submitted without prior stakeholder engagement, and with only a limited opportunity for stakeholders to respond. This action will likely have the effect of undermining any goodwill that AGN has built up with stakeholders through its earlier Stakeholder Engagement Program.

4. Operating Expenditure (opex)

Step Change – Inlet Data Capture Project

The AER DD did not accept any of the nine step changes proposed by AGN. In the AER's view, the new opex requirements identified by AGN do not relate to new obligations facing AGN, or other changes in AGN's circumstances requiring a material increase in opex for the 2016–21 access arrangement period.[8]

In response, AGN has re-proposed one step change – Project SA44 Inlet Data Capture at an unchanged cost of $1.7m.[9] We expect that a prudent and efficient network business operator is capturing information about the

[5] AGN, RAAP Information, page I
[6] AGN, RAAP Information, page I
[7] 2018-22 Powerlink Queensland Revenue Proposal Overview, page 2
[8] AER, Draft Decision Overview, page 43

location and condition of its assets as an ongoing 'business as usual' activity, and therefore do not agree that this activity should be considered as a business step change. We support the AER's DD not to accept this step change.

5. Capital Expenditure (capex)

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Mains Replacement Program (MRP)

The MRP is the largest single component of AGN's capex program, comprising around 50% of the proposed total capital expenditure. AGN's AAP included the replacement of 1273 km of CI/UPS and HDPE mains in 2016-21 at a cost of $369.9m. AER's DD revised the forecast capital expenditure on MRP downwards to a total of $167.7m, which equated to approximately 577 km of mains replacement. However, AER was basing its estimates on what it considered to be incomplete information, and invited AGN to provide additional information in support of its proposed MRP.

AGN's RAAP includes plans for replacement of 1265 km of CI/UPS and HDPE mains, prioritised according to risk, at a revised cost of $326m. The RAAP presents what it says is a comprehensive risk analysis based on AS/NZS 4645 Gas Distribution Network Management. It also claims to clarify AGN's regulatory compliance obligations under their Gas Distribution Licence, the *Gas Act 1997* and *Gas Regulations 2012* through their incorporation of AS/NZS 4645 and the Work *Health and Safety Act 2012*.[10]

We consider that the RAAP provides convincing justification to support a significant MRP in the next five years. However, we continue to question the extent of the program, and thus its cost and impact on the regulated asset base. AGN argues that the program is limited by delivery capability, which AGN holds to be of the order of 250 km of mains replacement per annum.[11]

We advise the AER to consider whether risk rating of individual program components would be a more appropriate criterion to use to assess whether a particular component may be included in the next five-year period, or deferred to subsequent periods.

Mount Barker

In its RAAP, AGN has included an additional Business Case relating to the expansion of the network to Mount Barker (SA25).[12] AGN has also re-proposed its Significant Extension Event Cost Pass Through, should the AER not accept the proposed capex in relation to this network extension. The Mount Barker high pressure mains extension project is estimated to cost $23.5m, with the first connections forecast to occur in 2021.[13] The mains extension is targeted to serve the new developments at Mount Barker.

The business case describes a new broad-acre master built development. It assumes approximately 7,000 new domestic connections over a 20-year period with a domestic penetration rate of 95%, compared with South Australia's average domestic penetration rate of 63%.[14] To achieve this penetration rate, AGN will need to be working very closely with the developers. It appears that beneficiaries of this project will be first, the developers, and second, the new domestic, commercial and demand customers in Mount Barker. Benefits to existing AGN customers appear to be minimal. We therefore advise the AER to review:

(a) The timing of the project, and the extent to which expenditure may be required in the 2016-21 period; and
(b) The option of requiring capital contributions from developers to offset the cost impost on existing customers who will obtain minimal benefit from this expenditure.

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[9] AGN, RAAP Attachment 7.8 Operating expenditure, page 6
[10] AGN, RAAP Attachment 8.10 Mains Replacement Program
[11] AGN, RAAP Attachment 8.10 Mains Replacement Program, page 3
[12] AGN, RAAP Attachment 7.1A Business Cases for operating and capital expenditure, page 25
[13] AGN, RAAP Attachment 7.1A Business Cases for operating and capital expenditure, pages 25 and 30
[14] AGN, RAAP Attachment 7.1A Business Cases for operating and capital expenditure, page 30

IT Capex

AGN's AAP included a proposed investment in IT of $66.7m over the next regulatory period. The AER's DD reduced this amount to $38m. This compares with an allowance of $12.1m for the previous regulatory period. The RAAP proposes an IT investment of $55m, which is more than four times the previous allowance.

In its DD, the AER did not accept two IT projects put forward by AGN viz. SA59 – Mobility Integration and SA60 Business Intelligence. These projects were rejected on the grounds that AER considered the work to be discretionary, and the business cases did not show a positive net present value. AGN has reproposed these two projects having updated the business cases to provide more information on problems with the existing systems, and to provide a more detailed assessment of the costs and benefits, resulting in positive NPVs for each project.[15]

These projects are both discretionary and rated as priority 3. The business cases do not present a clear justification for the proposed timing of the projects. Given the extraordinary increase in IT expenditure proposed for 2016-21, we question the need for all of this work to be undertaken in the 2016-21 timeframe, and suggest that the AER considers deferral of these two projects.

As identified in our previous advice, we have concerns regarding the capital cost allocation for IT investments targeting productivity improvements for the field workforce. Our understanding is that APA provides and manages the field workforce that operates and maintains AGN's assets. APA must be responsible for its own work and workforce management systems. Such systems should not form part of AGN's regulated asset base.

Should the AER determine that the project SA59 – Mobility Integration is appropriate to be undertaken during this period, we advise the AER to consider a suitable cost allocation arrangement.

Regulated Asset Base (RAB)

The revised proposal for capex over the next AA period will have the effect of increasing the RAB from $1,428.8m to $2,065.8m, an increase of 44%. The RAB is expected to nearly double over the 10 year period spanning the current and previous AA arrangements. This alarming rate of growth is occurring at a time of decreasing gas demand across the network. This results in higher prices for consumers being 'locked in' for both the next and future AA periods. AGN states that from 2016 onwards, price growth of 5% per annum is forecast in line with the growth in the RAB.[16] In this environment, we do not consider that the proposed rate of increase of the RAB, and hence prices, is in the best long term interests of consumers. We urge the AER to take all available measures to limit growth of AGN's regulated asset base to a level that is more consistent with actual demand trends.

6. Regulatory Depreciation

In its AAP, AGN proposed to apply the straight-line depreciation method over the 2016-21 access arrangement period. It proposed to apply the same standard asset lives as those approved by the AER over the 2011-16 access arrangement period. It also proposed to use the weighted average approach to determine the remaining asset life of the capital base at the start of the 2016-21 access arrangement period.[17]

AGN's proposal accounted for inflation by indexing its capital base, and calculating its regulatory depreciation allowance as straight-line depreciation less this indexation adjustment.[18] However, it submitted that this proposal was contingent on an assessment of two financial ratios used by credit rating agencies, labelled 'credit

[15] AGN, RAAP Attachment 7.1A Business Cases for operating and capital expenditure, pages 61 and 89
[16] AGN, RAAP Information, page I
[17] AGN, AAP Information, page 162
[18] AGN, AAP Information, page 165

metrics'.[19] AGN proposed that if this assessment indicated that it would not maintain the benchmark BBB+ credit rating, the AER should vary the indexation to the extent required to provide sufficient cash flow.[20]

AGN submitted that its proposal allowed it to maintain a BBB+ credit rating over the 2016-21 access arrangement period, so it was not necessary to vary the level of the indexation adjustment. However, AGN submitted that should the AER materially alter AGN's proposal, it was required to consider this contingent approach. [21] Specifically, AGN stated that if the AER did not accept its proposed rate of return on capital, it would require such a variation in the indexation component of its depreciation allowance.

The AER DD did not accept AGN's contingent proposal to adjust the indexation component of the regulatory depreciation allowance, for various reasons, including a statement that AGN's contingent proposal appeared to be incomplete and not fully specified. Therefore, the AER considered AGN's proposal to be incapable of being accepted. Among other specific criticisms, the AER DD found that AGN had overstated the importance of credit metrics as an indicator of creditworthiness, and had over simplified the approach of credit rating agencies.[22]

In its RAAP, AGN provided further documentation to support what it refers to as adjustments to the depreciation schedule to support its 'financeability'. AGN stated that it was seeking to ensure there are sufficient levels of cash flow to sustain credit metrics, which would enable debt to be raised at an efficient cost and facilitate efficient investment in the network.[23]

We note that AGN has said that there is no adverse long term impact on consumers from the application of its proposed financeability adjustment.[24] However, it would increase cash flows to AGN and hence prices to customers in the 2016-2021 regulatory period, and thus it is of concern to customers.

We advise the AER to analyse carefully the additional material provided by AGN, to see whether it is now complete, whether it complies with the requirements of the National Gas Rules, and whether it is really required and is in the long-term interests of customers.

7. Incentive Arrangements

Capital Efficiency Sharing Scheme (CESS)

In accordance with the view expressed in our previous advice, CCP8 supports application of a complementary CESS for a business which is also subject to an EBSS. We consider that the two schemes work together to promote efficient expenditure and to ensure that there is no bias towards one form of expenditure over another.

The AER did not accept AGN's proposal to introduce a CESS for the 2016-21 regulatory period. Its reasons for this decision include:

- The lack of stakeholder consultation with respect to the application of the existing CESS to gas businesses;
- Questions over whether AGN already has sufficient incentives to incur prudent and efficient capex; and
- A lack of standard quantifiable service reliability measures for gas distribution businesses.[25]

AGN has re-proposed introduction of a CESS in its RAAP.[26] Having considered the AER's DD, and the counter arguments put by AGN in the RAAP, we are persuaded that the lack of standard service reliability measures and

[19] AGN, AAP Information, pages 162-163
[20] AGN, AAP Information, pages 95-97, 163-164
[21] AGN, AAP Information, pages 95-97, 162-165
[22] AER, Draft Decision Attachment 5 Regulatory depreciation
[23] AGN, RAAP Attachment 9.5 Financeability
[24] AGN, RAAP Attachment 9. Financeability, page 7
[25] AER, Draft Decision Attachment 14 Other Incentive Schemes
[26] AGN, RAAP Attachment 12.1 Incentive Arrangements

the need for additional stakeholder consultation mean that it would be premature to introduce a CESS for the next AA period.

We note AGN's claim that the service reliability measures used for reporting performance to the Essential Services Commission of South Australia (ESCOSA) and to the South Australian Office of the Technical Regulator (OTR) are a sufficient set of service reliability measures for a gas distribution business.[27] However, there is a difference between reliability measures used for reporting performance, and financial incentives. We consider that the service reliability measures used for reporting performance to ESCOSA and to the OTR would form a very sound basis for a set of performance measures to complement a CESS scheme for a gas business. But we observe the absence in the case of AGN of the financial incentives that are incorporated in the Service Target Performance Incentive Scheme (STPIS) which applies to electricity networks.

Through the stakeholder engagement which informed the design of the CESS for electricity businesses, and the introduction of service reliability measures for AGN in the South Australian jurisdiction, much of the groundwork required to develop a robust CESS for application to gas businesses has already been completed. We urge the AER to prioritise the actions required to ensure that the CESS is fit-for-purpose for gas businesses leading into the next AA period.

8. Demand Forecasts

Demand is an important input into the derivation of AGN's reference tariffs. It also affects operating expenditure (opex) and capital expenditure (capex) linked to network growth (new connections).

We previously advised the AER that we had concerns with the demand forecasts that AGN included in its AAP. We emphasised to the AER the need to ensure that capex and opex proposals are in line with the demand forecasts. We pointed out that it is anomalous to see capex and opex growth forecasts to support ongoing network growth, while forecasts are showing demand declining at a fast rate. AGN's vision in its AAP[28] included "volume growth", which we suggested might be driving network investment plans that do not sit well with steeply declining demand forecasts.

In its DD,[29] the AER did not approve AGN's proposed demand forecasts. The AER's review of those forecasts identified concerns with the forecasting method that had been used to forecast tariff V residential and commercial consumption per connection. The AER was not satisfied that these forecasts comply with the National Gas Rules. The AER's DD found that the forecasts had not been made on a reasonable basis, and were not the best estimates in the circumstances.[30]

Instead, the AER developed alternative demand forecasts that it considered addressed these concerns, and comply with the National Gas Rules. The AER used these alternative demand forecasts in its DD.

In its RAAP, AGN stated in regard to demand forecasts that it "considers the AER Draft Decision provides for a reasonable opportunity to recover efficient costs over the next AA period, and as such, AGN has accepted the AER Draft Decision".[31]

We are satisfied that the AER's review of the demand forecasts in its DD was thorough and appropriate. With the acceptance by AGN of the demand forecasts in the AER DD, we do not see further issues in the demand forecasts. Rather, the AER should continue to probe the capex and opex forecasts, in line with the forecasts showing declining demand.

[27] AGN, RAAP Attachment 12.1 Incentive Arrangements, page 7
[28] AGN, RAAP Information, page 34
[29] AER, Draft Decision Attachment 13 Demand
[30] National Gas Rules, r. 74(2)
[31] AGN, RAAP Information, page VI

9. Pipeline Services

Metering and Meter Data Services

In our previous submission, we expressed concern about inconsistencies between the approach to metering and meter data services in electricity and gas networks. We advised that:

> *We consider that contestability in energy metering and meter data services is in the long term interests of all energy consumers in the NEM. In dual fuel areas, we envisage synergies for meter data service providers across electricity and gas meters. We advise the AER to consider moving towards a consistent approach to the issue of contestability of metering and meter data services across the NEM.*

In support of this position, we wish to draw the AER's attention to the emergence of new businesses which are providing metering and meter data services for electricity and gas customers in embedded networks.[32]

We suggest that it is timely for the AER to consider commencing disaggregation of metering and meter data services from Haulage Reference Services in the next round of Access Arrangement Reviews.

10. Stakeholder Engagement

Stakeholder Engagement Program

In our previous advice, we noted that AGN had developed and implemented a stakeholder engagement program to inform the initiatives set out in its proposal.[33] This was a relatively new approach for AGN. We considered that overall the Stakeholder Engagement Program was well-designed and comprehensive, and aligned closely with the AER's CE Guideline. Our observations and feedback from customers who participated in the program indicated that throughout the implementation of the program to date, AGN had demonstrated openness and a genuine commitment to meaningful engagement with its stakeholders.

In our previous advice, we included detailed feedback on specific aspects of AGN's Stakeholder Engagement Program, which are not repeated here, but which remain relevant for ongoing consideration.

In its RAAP, AGN notes that it intends to continue to engage with stakeholders throughout the remaining AA process.[34] We welcome AGN engaging in ongoing stakeholder engagement in accordance with the AER's CE Guideline, and observations and advice from the full CCP and CCP8 on how to conduct meaningful and appropriate stakeholder engagement, and how to interpret and treat the outcomes and findings from consumer engagement.

Use of Consumer Engagement to Inform Regulatory Proposals

We also note that in common with other energy network businesses, there has been no clear indication in the AGN AAP or the RAAP that AGN's consumer engagement activities have informed its regulatory proposals.

As a counter-example, we would like to bring AGN and the AER's attention to the regulatory proposal from TasNetworks. This regulatory proposal was submitted to the AER on 29 January 2016, for electricity distribution access arrangements to apply in Tasmania from 1 July 2017 to 30 June 2019,[35] and sets out how TasNetworks' consumer engagement has informed its regulatory proposal. By way of example, TasNetworks reported that its customers had told TasNetworks that they are satisfied with the reliability of our network, but want TasNetworks to do more to reduce electricity prices. TasNetworks has said that it is responding to this

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[32] As an example, the business METER2CASH Solutions (www.meter2cashsolutions.com.au) is growing quickly in south east Queensland

[33] AGN, Five Year Plan for the South Australian Natural Gas Distribution Network (2016-2021), Customer Overview, P9

[34] AGN, RAAP Information, Page IX

[35] Documentation for the TasNetworks access arrangements regulatory website can be accessed at http://aer.gov.au/networks-pipelines/determinations-access-arrangements/tasnetworks-formerly-aurora-energy-2017-2019

challenge by committing to the delivery of ongoing cost savings and efficiencies, over and above the savings already factored into its transmission charges.

We commend this approach. We would welcome all energy network businesses similarly setting out in their regulatory proposals and revised regulatory proposals how their consumer engagement activities have informed their regulatory proposals. We believe this would be in the interests of the National Electricity Objective / National Gas Objective as appropriate, and would assist in achieving the objectives of the AER's Consumer Engagement Guideline.

11. Conclusion

In conclusion, we wish to thank AGN for the opportunity to meet and discuss their revised proposal. We would also like to acknowledge the assistance of AER staff during this process.

David Prins and Robyn Robinson

CCP sub-panel 8

31 March 2016