

Advice to AER from Consumer Challenge Panel sub-panel 8 regarding the AER Draft Decision and ActewAGL Distribution's Revised Access Arrangement 2016-2021 Proposal

23 March 2016

1. Introduction

On 30 June 2015, ActewAGL Distribution (AAD) submitted a gas access arrangement proposal (AAP) for its ACT, Queanbeyan and Palerang gas 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 AAD's initial Access Arrangement 2016-21 proposal on 26 August 2015.²

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

AAD 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 AAD's Revised Access Arrangement 2016-21 Proposal (RAAP).

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

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

	AAD AAP	AER DD	AAD RAAP
Total Revenue	\$359.4m	\$301.0m	\$390.8m
Rate of Return	7.15%	6.09%	8.58%
Operating Expenditure	\$157.9m	\$144.6m	\$175.2m
Capital Expenditure	\$115.7m	\$76.8m	\$93.2m
Tariff Price Path (in real terms)	2.2% decrease in 2016/17, flat for remaining 4 years	25.7% decrease in 2016/17, increases of 1.0% pa for remaining 4 years	3.78% increase in 2016/17, flat for remaining 4 years

Source: AAD RAAP Response to the AER's draft decision page 21, AER DD

In its earlier advice, we stated that "we consider that ... a reduction in the total allowance is achievable through business efficiencies, and that this is the preferred outcome for consumers". Consistent with that, we endorse many aspects of the AER DD. In particular, we support:

- Adherence to the AER's Rate of Return Guideline, and the nominated 6.09% overall rate of return. This is clearly the major influence on the proposed lower tariffs for consumers.
- A reduction in the capital expenditure forecast. This has the effect of moderating the growth in AAD's regulated asset base, which is the driver for higher prices in future regulatory periods.

¹ <https://www.aer.gov.au/node/33382>

² <https://www.aer.gov.au/node/33382>

³ <https://www.aer.gov.au/node/33383>

⁴ <https://www.aer.gov.au/node/33384>

- Lower operating cost allowances based on the elimination of a number of proposed step changes from the operating expenditure forecasts.
- Application of a revenue reconciliation (true-up) for the 2015/16 extension year.
- Revision of demand forecasts.

Nevertheless, we continue to have residual concerns regarding aspects of both the AER's DD and AAD'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 are also relevant for AAD.

The AAD RAAP proposes a revised rate of return or Weighted Average Cost of Capital (WACC) of 8.58%. This is a significant departure from the WACC of 7.15% submitted in the AAP which, if implemented, would have a very large impact on consumers. AAD states: "Our revised proposal is aligned with our proposal for our electricity network, which is currently being considered by the Australian Competition Tribunal."⁵

In the absence of any justification based on changes in AAD's business environment since 30 June 2015, and the fact that a WACC of 7.15% was considered sufficient at that time, the proposed change to WACC presents as an opportunistic attempt to gain windfall profits at the expense of AAD'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.⁶ We advise the AER to reject the WACC proposal in AGN's RAAP.

We have seen no evidence of AAD undertaking stakeholder engagement with respect to this very significant change. The timing of the revision has provided only a limited opportunity for stakeholders to respond. This action will likely have the effect of undermining any goodwill that AAD has built up with stakeholders through its earlier Stakeholder Engagement Program.

4. Operating Expenditure (opex)

Step Change – 2021 Access Arrangement Review

The AER DD did not accept the '2021 Access Arrangement' step change proposed by AAD, but rather included a proportion (20 per cent) of the 2014-15 costs associated with preparation of the 2016-21 access arrangement proposal in its assessment of efficient base year costs.⁷ We are persuaded by AAD's claims that this approach is likely to:

- Understate the true cost of the activity over a 5 year period
- Lead to unintended interactions with operation of the Efficiency Carryover Mechanism
- Reduce the transparency of assessing AAD's performance against opex allowances.

In this case, we support the retention of the proposed opex step change. We do not, however, support the forecast of \$4 million for this step change. AAD states that the forecast has been increased to allow for issues it has experienced during the current AA process including "the extremely limited timeframe in which to respond to the draft decision" as well as "the volume and detail of information requests received".⁸ We observe that these are process issues that should be resolved between AER and AAD prior to the next AA period. These issues should not lead to additional costs for consumers.

⁵ AAD, RAAP Response to the AER's Draft Decision, page 20

⁶ 2018-22 Powerlink Queensland Revenue Proposal Overview, page 2

⁷ AER, Draft Decision Attachment 7, page 7-33

⁸ AAD, RAAP Response to the AER's Draft Decision, page 85

New Step Change – RSA tariff reassignment

AAD has proposed a new step change (\$0.77m) to meet the cost of manually processing tariff reassignment requests from existing customers and their retailers. AAD previously expected that the AAD / Jemena's IT systems could facilitate bulk customer transfers to the new tariffs. However, AAD is now saying that this has been found not to be the case.⁹

Reassignment of customers to new tariffs forms one element of a larger business change which is the introduction of new tariff structures in the 2016-21 access arrangement. These new arrangements were approved by the AER in its DD. We consider that within AAD, the business case for introducing new tariff structures would have identified the business benefits and expected increase in demand and revenues flowing from the proposed changes. In our view, the costs associated with implementing the change, i.e. the cost of manual data entry, should be offset by the expected increase in revenue. Therefore we do not support the proposed step change.

5. Regulated Asset Base (RAB)

The revised proposal for capex over the next AA period will have the effect of increasing the RAB from \$365.5m to \$432.7m, an increase of 18%.¹⁰ The RAB is expected to increase by 55% over the 11 year period spanning the current and previous AA arrangements. This rate of growth is occurring at a time of decreasing gas demand across the network. 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 AAD's regulated asset base to a level that is more consistent with actual demand trends.

6. Demand Forecasts

Demand is an important input into the derivation of AAD'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 were concerned that the new residential connections forecast that AAD has used in its AAP was based on an assumption that 90% of new dwellings will connect to the gas network on an ongoing basis. We advised that while it may have historic basis, this assumption of 90% take-up did not appear to have been subject to any discussion as regards to its applicability going forward. It was in contrast to the evidence that gas is a fuel of choice, and fewer households are choosing to connect to gas. There is evidence from research such as that which was undertaken by the Alternative Technology Association (ATA), which found that it is not cost effective to connect a new home to mains gas when efficient electric appliances are an option.¹¹

We suggested that the AER should consider whether this take-up rate was appropriate. We suggested that it might more accurately decline rather than stay constant during the next AA period.

In its DD,¹² the AER stated that its assessment was that ActewAGL's assumption of a 90 per cent gas connection rate was not the best estimate of future new gas connections, and instead derived alternative estimates.

The AER compared Core Energy's 90 per cent assumed gas connection rate for future gas connections to three data series. Each comparison demonstrated that a 90 per cent penetration rate is an overestimate.

⁹ AAD, RAAP Response to the AER's Draft Decision, page 85

¹⁰ AAD, RAAP Response to the AER's Draft Decision, page 31

¹¹ *Are we still cooking with gas?*, ATA, 2014, page 26, available at <http://www.ata.org.au/ata-research/new-report-on-economics-of-gaselectric-appliances>. Note: the two authors of this advice were acknowledged as stakeholders who contributed to the ATA project (see page 10 of the ATA report).

¹² AER, Draft Decision Attachment 13 Demand

Specifically:

- using historical connections data from Core Energy's demand model, new dwelling gas connections as a proportion of HIA new dwellings ranges between 49 to 71 per cent over 2010-11 to 2013-14;
- using the historical data from the capex unit rate model, new dwelling connections as a proportion of HIA new dwellings ranges between 50 to 69 per cent over 2010-11 to 2013-14;¹³ and
- the latest ABS statistics indicate that 67.9 per cent of all households in the ACT were connected with gas in 2014, down from 74.6 per cent from 2011.¹⁴

The most significant difference between the AAD AAP and the AER DD concerned the forecasts for new connections for medium density/high rise dwellings. In particular, AAD forecast a major increase in this type of new connections, while the AER forecast a decline, consistent with the decline in HIA's forecast relative to its four year historical average. The AER considered that its forecast was the best estimate in the circumstances, as it relied on actual historical data and HIA forecasts.

In its RAAP, AAD stated that while it did not necessarily agree with the AER's revised forecasting approach, it had accepted all aspects of the resultant forecasts as outlined in the AER DD aside from the connection forecasts for residential medium density and high rise dwellings. AAD considered that the gas penetration rate of 36 per cent used by the AER in the DD for medium density and high rise dwellings was likely to materially understate the penetration rate in connections for residential medium density and high rise dwellings over the 2016-21 access arrangement period. AAD adopted a revised penetration rate of 72 per cent, based on historical connections data over the period 2010/11 to 2013/14, to update its connections medium density and high rise forecasts.¹⁵

We support the AER DD decision not to accept AAD's original connection forecasts and to devise its own. We again advise that the AER should consider the take-up rate carefully to determine whether the gas penetration rates in its DD remain justifiable and appropriate.

7. 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.¹⁶

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.

¹³ This calculation is for all the three regions relative to new housing in the ACT. So it overstates the gas connection rate, which is between 48 percent and 66 per cent for the ACT.

¹⁴ ABS, *Environmental Issues: Energy Use and Conservation*, Catalog number 4602.0.55.001, March 2014 and March 2011 issues

¹⁵ AAD, RAAP Response to the AER's Draft Decision, Section 14

¹⁶ As an example, the business METER2CASH Solutions (www.meter2cashesolutions.com.au) is growing quickly in south east Queensland

8. Stakeholder Engagement

In our previous advice, we provided detailed comment on AAD's consumer engagement activities, but our advice did not extend to material issues that would materially affect the AER's DD.

In its DD, the AER stated that it considered that AAD had taken important steps to involving consumers in the regulatory process. Submissions received by the AER from ACT Council of Social Services (ACTCOSS), the North Canberra Community Council (NCCC), and Peter Sutherland of the ANU College of Law, and advice from the Consumer Challenge Panel, supported this view, and indicated that there are further opportunities for AAD (and the AER) to improve their engagement. The AER would consider this in developing its consumer engagement programs going forward, and encouraged AAD to do the same.¹⁷

In its RAAP, AAD stated that it intends to engage further with consumers, through its Energy Consumer Reference Council (ECRC) and wider consumer engagement program.¹⁸

We welcome these ongoing consumer engagement initiatives, and the taking of further opportunities to improve the consumer engagement frameworks.

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

As a counter-example, we would like to bring AAD 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 2019,¹⁹ 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 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.

9. Conclusion

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

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CCP sub-panel 8

23 March 2016

¹⁷ AER, Draft Decision Overview, page 60

¹⁸ AAD, RAAP Response to the AER's Draft Decision, page 105

¹⁹ 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>