Forum on the AER’s draft decision for ActewAGL’s ACT, Palerang and Queanbeyan gas distribution network

Location: ACCC, 23 Marcus Clarke Street Canberra

Date: Tuesday, 17 November 2009

Forum Chair: Mike Buckley, General Manager Network Regulation North, Australian Energy Regulator

Attendees: Refer to attachment

1. Overview of presentation (provided by Mike Buckley)

Slide 1: Outline of forum

The purpose is to:

- Outline the AER’s assessment and explain how it came to its draft decision on the ActewAGL access arrangement proposal.

- Provide an opportunity for interested parties to ask questions of the AER.

Slide 2: Background

- ActewAGL Distribution Partnership owns, operates and controls the ACT, Queanbeyan and Palerang gas distribution network. The partner companies are: ACTEW Distribution Ltd and Jemena Networks (ACT) Pty Ltd. These companies jointly control the network acting through the ActewAGL Joint Venture Partnerships Board. Neither of the partners can control the network individually.

- Jemena Asset Management (JAM) which provides asset management and operational services to ActewAGL network under contract. JAM is owned by Jemena Limited. ActewAGL’s capital expenditure programme and more than 80 per cent of its operating expenditure for support services is provided by JAM.

- ActewAGL’s network largely supports a low volume, residential customer base – 85 per cent of total load. Customer demand is heavily influenced by winter weather conditions.

- Load growth is driven by the growth in customer numbers. This is forecast to grow at 2.8 per cent in the current access period down from an annual growth rate of 3.1 per cent in the previous access arrangement period.

- Demand per tariff customer is forecast to decrease by almost 8 per cent over the access arrangement period.

- ActewAGL submitted its proposal to the AER on 30 June 2009 and it was published on 22 July 2009.

- This is the first review of the ActewAGL access arrangement proposal by the AER. The current access arrangement was approved by the ICRC.

- On 1 July 2008 the new National Gas Law (NGL) and National Gas Rules (NGR) came into operation. The NGL and NGR do not significantly impact how the AER assesses historic or forecast capital expenditure. The main change is the way total revenue is allocated to individual tariffs, and the move from a more direct cost of service tariff setting framework for distribution tariffs than prevailed under the Code.

- Consultants engaged by the AER:

  - Wilson Cook – Capital expenditure & operating expenditure

  - ACIL Tasman – Demand forecasts

  - Access Economics – Future labour input costs

- Submissions received from APA and SoftLaw Community Projects on the proposed HFL.

- The AER's draft decision was released on 11 November 2009. The decision requires ActewAGL to amend its access arrangement proposal.

Slide 3: Overview

- ActewAGL prepared a comprehensive and well supported proposal.

- The draft decision includes 73 revisions – most of these are minor and procedural in nature. The number of revisions is not an indicator of the quality of the proposal.

- The gas network is relative young (commissioned in 1981) – comparisons with older networks are always difficult.

- This presentation will focus on three issues arising from the review of the access arrangement proposal:
  - the efficiency of operating costs which are provided by means of an asset management contract
  - the substantial increase in proposed capital expenditure
  - the higher return on capital that is being sought.

- The AER's decision on the above issues means that network charges in 2010–11 will be 11.6 per cent higher than in 2009–10. Over the access arrangement period network charges will increase by an estimated 7.8 per cent.

Slide 4: Operating Expenditure

- ActewAGL proposed forecast total operating expenditure for the access arrangement period of $119.0 million ($2009–10). This is shown in slide 4.

- The proposed operating expenditure reflected the base year actual operating expenditure in 2009-10 of $19.69 million ($2009–10) with an uplift in the base year for:
    - step changes for regulatory requirements for changes in safety and technical requirements, as well as gas market related costs, for the market operator, STTM, CPRS
    - self insurance
    - incorporation of the UNFT (which was dealt with as a cost pass through in the current access arrangement period)
    - higher UAG costs

- Wilson Cook reviewed the base year operating expenditure and found it to be efficient, subject to revisions to some step changes.

- The issue for the AER and Wilson Cook in assessing the efficiency of the base year operating expenditure is the lack of detailed information relating to the JAM contract. The efficiency of the base year was in part assessed as being efficient by reference to a benchmarking study.

- The AER reduced ActewAGL's proposed total operating expenditure by $10.8 million ($2009–10) to $108.2 million ($2009–10) because of :
    - lower approved UAG prices and a lower approved level of UAG
    - proposed step changes for regulatory costs for the STTM, CPRS and AEMO fee were not approved, instead these are to be treated as cost pass through events when the timing and/or cost of these events is more certain
    - no approved self insurance operating expenditure.

- One key outcome to determine the efficiency of the operating costs over time is the development of the statement of costs which will provide the AER with more data on ActewAGL's operating expenditure on a disaggregated basis (including a detailed break down of JAM's costs).
    - more than 80 per cent of ActewAGL's operating expenditure consists of fees paid to JAM for its outsourced asset management services
    - rather than providing a detailed breakdown of costs with its access arrangement proposal, ActewAGL has used the findings of a benchmarking assessment to support its claim that its proposed costs are efficient
    - both the AER and Wilson Cook had reservations about ActewAGL's claim that the benchmarking study showed that ActewAGL was operating at least as efficiently as its peers. It is difficult to normalise that data used in benchmarking studies given the age and customer differences between networks
    - to this end, the AER has developed an information template in the form of a 'statement of costs' for ActewAGL to complete for each year of the access

arrangement period. This will enable the AER to more effectively look through the JAM contract for costs proposed for the next access arrangement period.

Slide 5: Capital Expenditure

- The AER has approved total capital expenditure for the access arrangement period of $81.4 million ($2009–10). This represents an increase in real terms of approximately 28 per cent over total capital expenditure for the earlier access arrangement period. This is shown in slide 5.

- Except for the HFL project, the AER has largely approved ActewAGL's proposed capital expenditure programme, as can be seen from the comparison of the proposed and approved columns. From the chart you will see that the proposed and approved capital expenditure columns are the same.

- The main capital expenditure program relates to:
    - capacity development programs of which the main one is the Tuggeranong primary mains extension and PRS totalling $13.1 million ($2009–10). This programme is largely delivered in the first few years of the access arrangement period with some preparatory work being undertaken in 2009-10
    - stay in business programs including a meter replacement program costing $11 million ($2009–10)
    - market expansion programs totalling $35 million ($2009–10).

Slide 6: Capital Expenditure – Hoskinstown to Fyshwick Loop

- The proposed HFL was expected to provide 88TJ of gas storage. As I noted in the introduction, the growth in demand for gas is slowing. The project, however, is aimed at meeting system security not augmentation. Demand on the network is highly variable the summer peak day demand is 7 TJ/day, while the winter peak is 70 TJ/day.

- As touched on previously, the AER has decided that the HFL project is not supported by a thorough economic analysis. The rejection of the proposed HFL will result in a decreased capital expenditure of $134 million ($2009–10) from an overall capital expenditure proposal of $214.4 million ($2009–10).

- The reasons for not supporting the need for the HFL is based on:
    - upstream gas supply improvements in security of supply to the ACT market with the commissioning of the QSN link, supplying gas from Queensland in addition to Moomba
    - risk mitigation strategies and improved information – ActewAGL has taken action to improve information gathering about short-term demand constraints especially with relevant shippers
    - the inadequacy of the business case for the HFL - by not providing an assessment of the benefits of the HFL, and not demonstrating what contingency needs to be provided for and whether the proposed capital expenditure on the HFL is the most appropriate means to address the risks
    - there is also uncertainty about nature of the services being provided and whether the HFL as a storage facility would be added to the capital base.

Slide 7: Weighted Average Cost of Capital

- The third substantive issue to be addressed today is the proposed cost of capital.

- ActewAGL proposes a nominal vanilla WACC of 11.09 per cent. For this draft decision, the AER has determined a nominal vanilla WACC of 10.14 per cent for ActewAGL.

- What this slide does not show is the risk free rate used to establish the WACC. The AER used a risk free rate of 5.49 per cent to establish the indicative WACC this is higher that the risk free rate at the time ActewAGL submitted it proposal. The risk free rate will be update at the time of the final decision.

- The AER has not accepted WACC parameters submitted by ActewAGL viz:
  - equity beta from 1.0 to 0.8
  - market risk premium from 7.5 per cent to 6.5 per cent
  - debt risk premium from 4.96 per cent to 4.28 per cent.

- As you can see from the table cost of capital established in the draft decision is significantly higher than in the previous access arrangement period, based on changes to market based parameters.

Slide 8: Tariffs

- The AER has made minor changes to classify some services as reference services i.e. ancillary services.

- Overall there will be an initial nominal increase for tariff (residential and small) customers of 11.6 per cent.
- This works out as an annual average increase over the five year period of 7.8 per cent.

- Contract or larger customers will experience an initial fall in tariffs of 11 per cent which will rise in line with CPI over the access arrangement period, where CPI is forecast at 2.45 per cent.

Slide 9: Components of tariff change

The AER estimates that of the increase in tariffs approved over the five years of the access arrangement 20 per cent can be attributed to the increase in operating expenditure, 20 per cent to the increase on WACC and 32 per cent to the new capital expenditure.

Slide 10: Tariff variations

- Tariffs will increase over the access arrangement period for annual changes in CPI, these changes are estimated using a CPI of 2.45 per cent over the access arrangement period.

- The NGR allows certain approved costs to be passed through during the access arrangement period under the cost pass through tariff variation mechanism.

- Costs that were not approved as step changes such as for the STTM, CPRS and proposed additional AEMO as well as some other costs e.g. the National Energy Customer Framework fees are likely to result in higher tariffs than outlined in the previous slides.

Slide 11: Non-tariff Terms & Conditions

- **Extension policy:** ActewAGL proposed that all extensions to, and expansions to the capacity of, the pipeline are automatically covered by the access arrangement. However, the AER has modified the extension policy to allow it the discretion to determine whether or not extensions are allowed under the access arrangement.

  Specifically, in the access arrangement proposal, high pressure pipeline extensions will need to be notified to the AER so it can decide whether it will be covered by the access arrangement.

  All expansions will be automatically treated as part of the covered pipeline and covered by the access arrangement.

- **Trigger event** has been included to account for the change in the NGL and NGR for the introduction of the retail energy and gas connections framework. The reason for this is that this may impact the terms and conditions of access for users.

Slide 12: Process

- The draft decision was released on 11 November 2009

- Our objective with the draft decision was to produce a decision as close as possible to the final decision that will be made by the AER. ActewAGL will be given until 6 January to respond to the AER's draft decision and its revised proposal will be published shortly after.

- There will be an opportunity for interested parties to comment on both the AER's draft decision and ActewAGL's response. Please note that these submissions on the draft decision and the revised proposal have a closing date of 12 February 2010.

- The current plan is for the AER to make its final decision in early April with the new network charges commencing from 1 July 2010.

- If the AER's decision is to refuse approval of a proposal, it is required to make an access arrangement proposal within 2 months of its final decision.

2. Questions from interested parties

Q1: Retail price increases

Bill Pearcy, ACAT:

You mentioned an 11 per cent increase in tariffs - what is the impact of this on retail prices?

Chris Bell, ActewAGL:

In general, 35 per cent of a retail tariff is reflected by the network charges.

Mike Buckley, AER:

The increase reflects the need for significant capital expenditure (for both stay-in-business and augmentation purposes), which has been recognised by the AER. Also, debt costs have increased by 3 percentage points.

Q2: Self insurance

Garth Crawford, ENA:

Could you give more explanation on your decision on the self insurance operating expenditure?

Mike Buckley, AER:

None of the self insurance costs have been approved. The AER acknowledges that it is difficult to accurately determine the magnitude and likelihood of each adverse event. The ActewAGL proposal set out those certain adverse events which could be dealt with via self insurance, pass through or tariff variation. The AER does not disagree that these adverse events can occur—but without knowing the magnitude/frequency, implementing these as a cost pass through (rather than self insurance) balances risks more appropriately. In effect, we are determining how the costs are spread between current users and future users. The AER considers that it may be possible in the future to develop better forecasts that more clearly define the magnitude/frequency. The current regime allows ActewAGL to get the money back if an adverse event does occur, provided it is above a minimum threshold.

Gwenda Gleeson, AER:

There are provisions for a general cost pass through, which could encompass many possible adverse events.

Q3: Escalators

Chris Bell, ActewAGL:

The AER is not critical of ActewAGL's escalator methodology (labour and materials) as such, but indicates it wanted up-to-date numbers for the draft decision. Will these numbers be updated in future? Should ActewAGL provide this update?

Mike Buckley, AER:

The AER has been developing its own database on materials costs and will be receiving a revised version of the Access Economics' report on labour costs. The AER did not accept all aspects of ActewAGL's proposed cost escalators, notably polyethylene. The methodology was always intended to incorporate real cost decreases as well as real cost increases.

Chris Bell, ActewAGL:

We have seen strong wage growth recently, but the Access Economics labour figures are relatively flat.

Mike Buckley. AER:

It is true that there has been strong wage growth with utilities sector wages diverging from general wages. Access Economics are predicting a return to trend. If there is a change in the outlook then this will be included in the updated report and final decision.

<u>Q4: Expansions, extensions and information requirements</u>

Chris Bell, ActewAGL:

Rules regarding extensions and expansions have been tightened. The proposed method of dealing with extensions and expansions has been part of the past two access arrangements—what was the motivation for changing this?

Mike Buckley, AER:

Consistency with access arrangements for other networks. Low pressure suburban pipes are not included in the tightened arrangement. However, the high pressure pipelines require more consideration; the AER wants to look at costs and benefits associated with expenditure being added to the capital base and additional costs being imposed upon existing users.

Macleay Connelly, ActewAGL:

What is the definition of high pressure?

Gwenda Gleeson, AER:

The categories are defined to match the ActewAGL asset breakdown.

Alex Curran, ActewAGL:

Doesn't this overlap with rule 80 of the NGR? ActewAGL understands that there is a distinction between (1) everything covered (i.e. it is included as part of regulatory interest) and (2) everything conforms (i.e. it is added to the capital base). Doesn't the amendment overlap these rules?

Gwenda Gleeson, AER:

The extensions and expansions policy in the draft decision is about avoiding ‘automatic coverage’. Costly expansions need to be assessed. We don’t want to encumber the rights of the service provider.

Alex Curran, ActewAGL:

What about the additional information requirements for low pressure pipes?

Gwenda Gleeson, AER:

This allows us to obtain information on capital expenditure during the access arrangement period, and therefore stop these low pressure additions (‘infill developments’) being a black box.

Macleay Connelly, ActewAGL:

Would a 300m long high pressure pipe into a new building be included as a high pressure extension?

Gwenda Gleeson, AER:

It is not our intention to include that.

Mike Buckley, AER

Maybe a better way to look at this is to say that an extension to the new Molonglo suburb is ‘in’ but an extension to Gundaroo is not automatically ‘in’.

Alex Curran, ActewAGL:

Also information requirements—there are practical problems implementing this.

Gwenda Gleeson, AER:

The revised proposal would be a good place to bring this issue up and the AER would be happy to discuss this matter with ActewAGL prior to the submission of the revised proposal.

Attachment 1: Attendees

Name	Organisation
Maree Richards	Country Energy
Danielle Beinhart	Jemena
David Anthonisz	Jemena
Bill Pearcy	ACAT Energy and Water
Garth Crawford	ENA
Sean Das	Department of Environment, Climate Change, Energy and Water
Mick Charlton	ActewAGL
David Graham	ActewAGL
Eli Hefter	ActewAGL
Bjorn Tibell	ActewAGL
Chris Bell	ActewAGL
Alex Curran	ActewAGL
Macleay Connelly	ActewAGL
Chris Walker	ActewAGL
Mike Buckley	AER
Ben Stonehouse	AER
Eamon McGinn	AER
Trevor Johnston	AER
John Bastick	AER
Gwenda Gleeson	AER