10 August 2020

Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Email: AGNSA2021@aer.gov.au

Dear Mr Roberts

RE: Submission to AGN (SA) access arrangement proposal

Origin Energy (Origin) appreciate the opportunity to provide a response to the regulatory proposal lodged by Australian Gas Networks (AGN) for its South Australian gas distribution network for the period from 1 July 2021 to 30 June 2026.

The COVID-19 pandemic is expected to have an unknown, but significant impact on gas demand and expenditure both within the current regulatory period and likely extending into the next. AGN and the AER will need to carefully consider how to incorporate this uncertainty into the 2021-26 Access Arrangement decision. In the first instance, we anticipate that AGN's demand and expenditure forecasts may need to be substantially revised over the review period as COVID-19 impacts become clearer.

We note the South Australian Government emissions strategies and the setting of an aspirational target of net zero emissions by 2050. While the potential impacts are not immediate, the policies have implications for AGN in terms of how it utilises the existing network, future expansion of the network and the potential risk of asset stranding. This has implications for the development of the 2021-26 Access Arrangement proposal and its assessment. At this stage we are supportive of the proposed AGN approach to these issues. Specifically, we endorse AGN's proposal to delay accelerated depreciation of network assets in favour of a preferred price path for customers. Notwithstanding, the prospect of asset stranding in the face of decarbonisation presents a significant challenge for gas networks. We request that the AER provide a clear and documented regulatory position on the treatment of this issue (and the related assets) over this and future regulatory periods, This will provide networks and consumers with a better understanding of the risks associated with future gas network investments, and the implications for networks and consumers.

Origin support the significant progress the AER and AGN have made in driving the network towards achieving more efficient expenditure levels. Notwithstanding, the price reductions for the 2021-26 period are largely driven by a reduction in WACC rather than expenditure reductions. We are concerned that, absent these exogenous factors, prices would rise under AGN's proposal.

Finally, we would like to acknowledge the stakeholder engagement program undertaken by AGN and commend AGN for their thoroughness and inclusiveness.

Origin's response to specific issues identified in the proposal are set out below.

Operating expenditure

AGN forecast operating expenditure (opex) of $357.4 million in the 2021-26 period, $26.9 million (8%) higher than estimated opex in the current period. Key divers of the increase include:

Origin Energy Limited ABN 30 000 051 696• Level 32, Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000
GPO Box 5376, Barangaroo NSW 2000 • Telephone (02) 8345 5000 • Facsimile (02) 9252 9244 • www.originenergy.com.au

- a modest increase in customer connections;
- a forecast increase in labour costs;
- step changes for vulnerable customer assistance program, digital customer experience and insurance costs; and
- increased costs of unaccounted for gas.

Labour costs are forecast to increase on average 0.8% per year in real terms over the regulatory period. AGN determine labour cost forecasts based on the average of Wage Price Index forecasts developed by Deloitte Access Economics and BIS Oxford. While the averaging approach is consistent with the AER's final position in the recent Jemena Gas NSW decision, there is a considerable variance between the two sets of forecasts (Table 7.6 of the AGN proposal). It is unclear that the BIS Oxford forecasts incorporate the impact of COVID-19, which has clearly resulted in higher unemployment rates and increased income uncertainty. While Deloitte Access Economics forecast considerably lower real labour growth, we require additional information on these forecasts in order to comment (Attachment 7.8.1 containing the Deloitte Access Economics forecasts has not been provided). In the current economic environment we would expect minimal (if any) growth in labour costs at least in the short-term. We appreciate that the uncertainty surrounding COVID-19 impacts and its duration complicates the forecasting process and can produce a variety of outcomes depending on the underpinning assumptions, including the extent and duration of COVID-19 impacts. It is important that the AER critically assess labour cost forecasts (and other input cost forecasts) and provide sufficient flexibility in the assessment process for forecasts to be reviewed as the economic outlook becomes clearer.

AGN has incorporated a 0.4% per annum productivity improvement in the forecasts. While we support the application of a productivity growth factor, in the absence of appropriate productivity benchmarking we are unable to comment on the quantum of the proposed improvement or how it compares to other gas distribution networks. We note for example that Evoenergy proposes a 0.5% per annum productivity growth factor in its recent ACT gas proposal. We consider the AER needs to validate the efficacy of the proposed productivity improvements. This should preferably be undertaken using benchmarking data for gas networks to assist in the assessment of proposed productivity growth factors.

Capital expenditure

AGN forecast capex of $578.8 million in the 2021-26 period, $20.5 million (3.4%) lower than expected expenditure in the current regulatory period. Expenditure on growth and customer service are both expected to decrease, reflecting a reduction in expected connection growth and a reduced meter replacement program. Conversely, expenditure on public safety and reliability is forecast to increase, primarily as a result of the mains replacement program.

AGN has decided not to proceed with the previous Draft Plan proposal to expense a number of overheads that are currently treated as capital overheads. Appropriate cost allocation is a fundamental component of regulatory accounts. In recent Access Arrangements we note the ease with which costs are migrated between expensing and capitalising and vice versa seemingly with little reference to cost causation. We consider that cost allocation should be based on the principle of causation. That is, costs are required to be attributed in accordance with the activities which cause the costs to be incurred. We request that the AER adopt a more principled approach to cost allocation to ensure compliance with accepted cost allocation principles.

AGN's capex forecasting process appears reasonable, however given current and developing economic conditions, we consider that forecast demand may be more subdued necessitating a review of capex, particularly growth-related expenditure. We note that the regulatory asset base (RAB) is forecast to increase around 13.7% over the regulatory period, with the RAB per customer increasing around 7.5%. Given the trend toward decarbonisation, it is important that AGN strike a balance between maintaining/growing the current natural gas network and preparing for a zero net carbon emissions environment. We appreciate there is considerable uncertainty regarding the potential transition to hydrogen and the ability to adapt the current network to accommodate hydrogen. This uncertainty heightens the potential asset stranding risk. In assessing forecast capex and in particular growth-related capex, the AER need to be cognisant of the uncertain future facing the gas sector and the potential asset stranding risk associated with forecast capex. We consider the AER's assessment of proposed capex should seek to limit exposure to potential asset stranding risk. More broadly, Origin recommend that the AER explore the issue of asset stranding risk with a view to developing a consistent and equitable approach to addressing any asset stranding that arises.

Demand

AGN's consultant Core Energy & Resources (Core) derived demand forecasts for residential, commercial and industrial customers. Core forecast a modest increase in residential connections. However, it also forecast total demand for the residential sector to decline (1.5% per year) in response to higher wholesale gas prices, increasing penetration of solar energy, improved appliance and dwelling efficiency and lower new dwellings growth. Growth in the commercial segment is forecast to increase (0.3% per year) in response to increased connections underpinned by slightly higher projected levels of economic activity in South Australia. Industrial connections are forecast to fall (2.9% per year) in response to higher wholesale gas prices.

Core indicates that COVID-19 impacts have been incorporated in the forecasts, particularly in relation to residential demand where Core forecasts a sharp decline in the number of dwelling connections in 2021 with connections growth recovery albeit at a moderately reduced rate- beyond the COVID pandemic recovery. While Core acknowledge the impact of the pandemic on commercial and industrial customers, Core notes the potential for material downside risk in these forecasts.

We consider that there remains considerable uncertainty surrounding the impacts of COVID-19, particularly the extent and duration of impacts. It is vital that the AER and AGN ensure that that demand forecasts are updated progressively as more data comes to hand and the implications for expenditure and prices as economic conditions become clearer. It may also be pertinent for the AER to clarify the conditions under which a potential re-opening of an Access Arrangement Decision would be considered given the uncertainty surrounding COVID-19 impacts.

Incentive schemes

To complement the existing opex efficiency benefit sharing scheme (EBSS), AGN propose to introduce a capex efficiency sharing scheme (CESS). We are generally supportive of incentive regimes that interact with one another to ensure the completeness of the regulatory framework. This will the framework does not create perverse incentives to favour one form of expenditure or savings over another and to provide appropriate safeguards to ensure that service quality does not deteriorate as a result of any efficiencies.

Tariffs

AGN propose no change to the current pricing structures for the 2021-26 period:

- both the residential and commercial tariffs include a fixed supply charge and declining consumption blocks; and
- the demand tariff classes consist of a number of banded Maximum Daily Quantity (MDQ) charging parameters. The first band effectively represents a fixed charge as a minimum chargeable MDQ with the remainder being declining blocks.

We consider the use of declining blocks is an appropriate means of promoting increased gas utilisation in the face of a general decline in overall consumption. However, while we appreciate AGN's motivation for seeking to increase consumption, this appears at odds with the South Australian Government objective of reducing gas dependence over time. We would appreciate further detail in this area to better understand the pricing options available to AGN and how these interact with Government policy.

Ancillary services

We note that AGN propose no change to ancillary reference service categories and forecast an increase in charges of CPI per annum. We consider this to be a reasonable approach.

Reference Service Agreement

Clause 33.4 Service Indemnity and clause 33.5 Curtailment Indemnity

In relation to clauses 33.4 and 33.5, AGN propose that the network user will indemnify AGN against all loss, cost, expense or damage which AGN might suffer in relation to distribution services and any curtailment or interruption of the delivery of gas respectively.

We consider that Origin's liability under indemnities should be capped at a mutually agreed level. Furthermore, the language in the indemnities should better align with what a court would hold Origin liable for under common law. This would help to ensure the indemnities themselves are more balanced.

Yours sincerely

[redacted]

Sean Greenup
Group Manager Regulatory Policy