Technical Report:
Response to AER Draft Decision & AGN SA Revised Access Arrangement Proposal – 2021-26

Prepared by

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1. EXECUTIVE SUMMARY

TRAC Partners (**TRAC**) has been asked by Energy Consumes Australia (**ECA**) to provide expert regulatory advice on Australian Gas Networks SA's (**AGNSA**) revised access arrangement proposal for the 2021-26 period which was submitted to the Australian Energy Regulator (**AER**) in January 2021 (**Revised AA Proposal**) in response to the AER's Draft Decision of November 2020 (**AER DD**).

This report will assist submissions by ECA and other consumer organisations on AGNSA's Revised AA Proposal and the AER DD. It follows a report TRAC prepared for the ECA in August 2020 which reviewed AGNSA's original access arrangement proposal submitted to the AER in June 2020 (**Original AA Proposal**).

The ECA has asked TRAC whether AGNSA's Revised AA Proposal, when considered in its entirety, is capable of acceptance by the AER. In particular, TRAC has been asked to:

- identify material evidence gaps in the Revised AA Proposal, particularly in relation to the matters we raised in connection with AGNSA's Original AA Proposal;
- respond to the aspects of AGNSA's Revised AA Proposal which cover topics where the AER DD has requested further information to enable the AER to reach a settled position in the final decision; and form a view as to whether:
    - we are satisfied with the further information provided by the business; and
    - we support the business' position adopted in respect of each topic; and
- consider whether AGNSA's Revised AA Proposal reflects the long-term interests of SA gas customers with respect to price and quality of services, both in terms of the proposal in its entirety and in respect of each of the elements used to determine the reference tariffs being proposed.

In so doing, TRAC has reviewed the Revised AA Proposal, the AER DD and AGNSA's supporting documentation submitted together with the Revised AA Proposal.

Relevance of AGNSA's Consumer Engagement Approach

We also comment on an overarching statement made by the AER in section 1.4 of the Draft Decision relating to the relevance of AGNSA's consumer engagement in the AER's assessment of the Original AA Proposal under the statutory framework of the National Gas Rules (**NGR**) and National Gas Law (**NGL**).

It gives rise to two issues.

Firstly, the role that consumer engagement plays in assessing the revenue proposals of businesses. While consumer engagement is an important consideration, it should not be a proxy for consistency with the National Gas Objective. Consumer engagement is only one of a number of factors that the regulator must take into account.

The second issue that the AER's statement gives rise to is what is relevant information that the AER must take into account when performing its statutory role. It is important for all relevant information to be considered by the AER, not just the subset of relevant information referred to in the AER's statement.

This is discussed in more detail in section 2 of our report.

Topics where the AER has requested further information

In the AER DD, the AER requested further information in relation to a number of matters contained in the Original AA Proposal to enable it to be able to properly assess them in the final decision. They were:

- the inclusion in its forecast opex of amounts for the initiatives under AGNSA's vulnerable customer assistance program;
- the replacement program for some of AGN's cast iron and High-Density Polyethylene (HDPE) pipes;
- some of AGN's valve replacement and pipeline modification programs; and
- demand forecasts.

TRAC's position on the adequacy of the further information provided by AGNSA in support of each element of its Revised AA Proposal is as follows:

- in relation to the additional information to support the continued inclusion in its forecast opex of amounts for the initiatives under AGNSA's vulnerable customer assistance program – see section 7 of this report;
- in relation to the additional information to support the retention of additional capex for the replacement program for some of AGN's cast iron and High-Density Polyethylene (HDPE) pipes – see section 6 of this report;
- it would appear that the additional information provided in relation to the following topics indicate that the positions adopted by AGNSA in respect of these topics are capable of acceptance by the AER:
    - the retention of capex for some of AGNSA's valve replacement and pipeline modification programs; and
    - the revised demand forecasts.

Extent to which AGNSA's Revised AA Proposal is in Consumer's Long-Term Interests

We note that the AER DD, if implemented at the time of the submission of AGNSA's Revised AA Proposal, would result in a $100m reduction in allowable revenue over the 5-year plan compared with AGNSA's Original AA Proposal but that AGNSA's Revised AA Proposal is proposing an increase of $96m in allowable revenue over the 5-year plan compared with the AER DD[1].

The most significant drivers of the $96m increase in total revenue in the Revised AA Proposal (relative to the amount allowed in the AER DD) are:

- AGNSA has adopted the AER's latest methodology for estimating inflation which was released following the release of the AER DD ($37m);
- AGNSA has increased the regulatory depreciation allowance by $55m, largely because AGNSA has not accepted all of the proposed reductions in forecast capex (primarily for mains replacement capex) proposed in the AER DD;
- AGN has not accepted all of the opex reductions from the AER DD, resulting in an increased opex allowance of $22m; and

[1] AGNSA Revised Formal Plan, p10

offsetting these drivers that increase the revenue, there are a couple of drivers that reduce the revenue:

- the market variable elements in the rate of return calculation having reduced further from the time of the AER DD, resulting in a further reduction of $15m (noting that AGNSA does not disagree with the AER's methodology or approach).
- The decision to not proceed with the Mt Barker extension.

Notwithstanding the above, the positions adopted by AGNSA in relation to the following elements of its Revised AA Proposal would appear to contain sufficient information and be proposing methodologies and values which we believe are capable of acceptance by the AER in the final decision:

- The level of actual capital expenditure incurred for the 2016-21 period (including for 2015-16), subject to the AER reviewing the detailed information provided by AGNSA supporting the level of actual expenditure.
- The approach to establishing the opening capital base for 1 July 2021.
- The methodology for determining the rate of return. Although we note that the values of some of the parameters being proposed differ from those that have been proposed by Evoenergy for its revised AA proposal even though both businesses have adopted the same methodology. This is addressed in section 5 of this report.
- The approach to the setting of asset lives for the purposes of regulatory depreciation. Having said that, we have responded to the additional information provided by AGNSA in section 3 of this report.

Having regard to the above, we believe that there are still a number of key aspects of AGNSA's Revised AA Proposal which require amendment or further consideration by the AER before we would recommend it being accepted by ECA as being in the long-term interests of consumers and consistent with achieving the National Gas Objective. This is because of the reasons outlined in this report. Table 1 summarises our position on each of the key building blocks of the Revised AA Proposal.

Table 1: Key aspects of AGNSA's Revised AA Proposal

Element of Revised AA Proposal	Capable of Acceptance	Materiality	Key Findings
Opening Capital Base	Yes	N/A	This is capable of acceptance
Depreciation of capital base	Largely, yes	$503m for the 5-year plan	While we support the position adopted in relation to asset lives and the balance of the methodology for determining regulatory depreciation, we comment on the supporting paper contained in Attachment 9.6 to the Revised AA Proposal in section 3 of this report.
Rate of Return	Largely, yes	$15m less than the AER DD	While AGNSA adopted the AER's methodology, the values for key elements adopted by the AER in the DD differ from the Original AA Proposal because updated market data and a different inflation assumption are used by the AER. We note that AGN SA's Revised AA Proposal proposes a value for its rate of return (i.e., an average of 4.16% during the 5-year plan) that differs to the value proposed by Evoenergy in its revised proposal submitted to the AER at the same time. This is addressed in section 5 of this report.
Forecast Operating Expenditure	Partly	$21m more than the AER DD	We are not convinced that the additional information submitted by AGNSA to support the retention of the opex relating to the following items are appropriate: - The vulnerable customer assistance program - The digital customer experience project - The replacement of a portion of UAFG with renewable gas. These matters are dealt with in section 7.

Element of Revised AA Proposal	Capable of Acceptance	Materiality	Key Findings
Capital Expenditure – Extension to Mt Barker	Yes, but qualified	$28m of actual capex	While we accept AGNSA has the final decision whether or not to proceed with funding this project, we are concerned at justification for making this decision – i.e., that the regulatory framework didn't provide adequate incentives to justify proceeding with this project and the reasoning given by AGNSA to support the justification. This is addressed in section 4 of the report.
Forecast Capital Expenditure – Mains replacement	Yes	$529m proposed for the 5-year plan	See section 6.
Demand	Yes	N/A	The approach to developing a forecast based on numerous expert reports suggests that it is the best estimate. It has also been updated to remove additional growth from the no longer proceeding Mt Barker extension project.
Price Path	Largely, yes	Financeability	See section 5.

2. RELEVANCE OF CONSUMER ENGAGEMENT

Before commenting on specific elements of the AER DD and the Revised AA Proposal submitted by AGNSA, this report responds to an overarching statement made by the AER in section 1.4 of the Draft Decision relating to the relevance of AGNSA's consumer engagement in its assessment of the Original AA Proposal under the statutory framework of the NGR and NGL:

> *"Once we have considered the nature, scope and impact of the consumer engagement, AER's final step is to consider whether the outcome as presented by AGN is in the long-term interests of consumers. We do this undertaking our standard process - compare allowances proposed by AGN with those our established models and approaches suggest represent alternative estimates. If AGN's proposal aligns with or is below our estimates, we are able to have greater confidence that the results of the consumer engagement are in the long-term interests of consumers."*[2]

The AER's statement gives rise to two matters.

Role of consumer engagement in the regulator's decision making

Firstly, the role that consumer engagement plays in assessing the revenue proposals of businesses. While we fully support meaningful and targeted consumer engagement as a prudent and important step in the process of developing a revenue proposal by a regulated business, TRAC believes that the regulator should not place undue importance on the consumer engagement process undertaken by the business when undertaking its statutory role of assessing a revenue proposal.

This is so for a number of reasons:

- Firstly, the NGL and National Gas Rules (**NGR**) and National Gas Law (**NGL**) require that there are specific factors that the AER must consider when performing its statutory function of assessing an AA Proposal (for example, the National Gas Objective and the Revenue and Pricing Principles, among other factors). The AER cannot acquit itself of its statutory function solely by relying on the service provider claiming that its AA Proposal is a direct reflection of customers' preferences. Reflecting in an access arrangement proposal the outcomes of consumer engagement is not a proxy for achieving the National Gas Objective.
- Secondly, the AER's statutory role under the NGR and NGL is to (among other things) assess whether the Revised AA Proposal is consistent with, and will or is likely to contribute to the achievement of, the National Gas Objective – being "to promote efficient investment in, and efficient operation and use of, natural gas services for the long-term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas."[3]

  This statutory role is not an easy one to correctly perform. However, as the AER itself notes, it involves the consideration of a range of information and data. But it should not be the case that just because there was some form of consumer engagement, that it therefore follows that the proposal submitted by the business can be said to be consistent with, and does or is likely to contribute towards, the National Gas Objective. Nor should it be concluded that just because the nature, scope and impact of the consumer engagement has been assessed by the AER and considered to be effective, that the proposal submitted by the business is consistent with, and does or is likely to contribute towards, the National Gas Objective.

Relevant information the AER must take into account when performing its statutory role

The second issue that the AER's statement gives rise to is what is relevant information that the AER must take into account when performing its statutory role. While the AER's statement mentions this covers

[2] AER Draft Decision Overview, p 23
[3] National Gas Law – section 28 and National Gas Rule, Rule 100

consumer engagement and comparing "*allowances proposed by AGNSA with those our established models and approaches suggest represent alternative estimates*", there are other relevant sources of information that the AER must take into account. For example, submissions made by stakeholders must be taken into account by the regulator, although it is noted in the AER DD the AER has considered the submissions. But so too would expert advice obtained by the AER and stakeholders need to be taken into account. It is important for all relevant information to be considered by the AER, not just a subset of relevant information.

We would therefore encourage the AER to ensure that undertaking its own independent review of the Revised AA Proposal by reference to all relevant information, not just "established models and approaches that suggest alternative estimates", is the primary and fundamental basis for considering whether the Revised AA Proposal is consistent with and is contributing towards the National Gas Objective and that the thoroughness of consumer engagement is not the main driver for this assessment.

3. THE FUTURE ROLE OF DISTRIBUTION NETWORKS

Context

Two of the key issues in the most recent round of revenue reviews for gas distribution network re-sets[4] have been:

- governments' policies on the future of gas as an energy source for consumers; and
- the increased competition of alternative energy sources and means by which energy is delivered for use by consumers,

and the impact that this has on the expected demand for use of networks, the setting of tariffs for the networks and, in turn, the delivered cost of gas for consumers.

From a consumers' perspective, this ultimately has an impact on the future role of gas distribution networks.

These issues are not being addressed consistently either by Australian governments or by the owners of gas distribution businesses. For example, in the case of governments:

- the Prime Minister stated on 15 September 2020 that gas is an important part of the Commonwealth Government's plan to reduce emissions without imposing new costs on households, while at the same time creating jobs, growing businesses and the economy and maintaining choice for the energy consumer[5];
- in states such as South Australia, Queensland and Victoria, the state governments have taken more active policy approaches to promote the hydrogen industry. For example, in Queensland, a hydrogen industry strategy has been developed which focuses on supporting innovation, facilitating private sector investment, ensuring an effective policy framework and building community awareness and confidence in hydrogen. Moreover, in South Australia, the state government has developed a Hydrogen Action Plan which outlines 20 actions to help scale up renewable hydrogen production for export and domestic consumption. Not only are they aimed at underpinning a safe and secure hydrogen export sector, they are also aimed at accelerating hydrogen into the SA domestic economy. Whereas
- in the Australian Capital Territory however, the ACT Labor and the ACT Greens have entered into a Parliamentary and Governing Agreement[6] under which they agree to phase out fossil fuel gas in the ACT by 2045 at least by doing the following (among other things):
    - Implement a program that will educate people about energy efficiency and the shift from gas to electric.
    - Legislate to prevent new gas mains network connections to future stages of greenfield residential development in the ACT in 2021-22.
    - Work with industry and other stakeholders, to advance all-electric infill developments, with a goal of no new gas mains network connections to future infill developments from 2023.

Furthermore, in the case of gas distribution businesses, while all have considered this issue in the current round of revised AA proposals submitted to the AER, they have only given thought to it in the context of how it affects the depreciation profile in determining the return of capital to be allowed in the total revenue

[4] Jemena Gas Networks AA review 2020-25, Evoenergy Network AA review 2021-26 and AGN SA Network AA review 2021-26

[5] Media Release, Prime Minister of Australia, 15 September 2020

[6] Parliamentary & Governing Agreement for the 10th Legislative Assembly of the Australian Capital Territory

for the revised access arrangements. But even in this context, the businesses have approached it differently. For example:

- In SA, AGNSA has not proposed any reduction in asset lives in response to potential changes to the future of the energy sector; and
- In the ACT, Evoenergy has proposed that it will accelerate the depreciation of investment in new assets from 2021 onwards with shorter asset lives than for existing assets.

Although it should be noted that there could well be significantly different drivers in for each business for this difference in approach. The key reasons for the difference in approach may well include the following:

- as mentioned above, the differences in policy and legislative frameworks in the two jurisdictions. In the ACT, the government has a legislated net-zero target whereas in SA, the government has not and moreover is actively investing in hydrogen. This reflects different risk profiles for the future of each of these distribution networks.
- Evoenergy is the owner of both the gas and electric distribution networks in the ACT whereas AGNSA (and the Australian Gas Infrastructure Group of which AGNSA forms part) only owns gas infrastructure assets. Evoenergy's more diverse asset portfolio may have meant addressing the impact of stranded asset risk through accelerated depreciation - which therefore will make gas less affordable for today's customers – will be a less risky outcome for its overall business because any impact this might have on usage of the network may not affect its overall business because there is likely to be a commensurate uplift in electricity demand which will improve the financial performance of its electricity business.
- Evoenergy is partly owned by the ACT government which has mandated a move away from non-renewable gas. It could well be that, as a major shareholder, this has been a major influence in Evoenergy's approach for the Revised AA Proposal.

Should a distribution network play a future in delivering energy to consumers?

In deciding whether something needs to be done, the threshold question should be asked whether there should be a future role for distribution networks.

It is very much aligned to the core objectives of the ECA that distribution networks continue to play a future in delivering energy to consumers.

- *Providing genuine choice for households and small businesses.* Distribution networks facilitate energy diversity and choice for customers. Removing this choice has the potential for the following negative consequences for customers:
    - Reliance on a single energy source – such as electricity – increases the risks to energy consumers of a reliable energy supply. As has been seen in the past, East Australia's electricity grid has faced reliability issues on several occasions in recent years even with the diversity of natural gas.
    - It is important that consumers have diverse sources of energy from which to choose. Choice drives competitive pricing tension. As AGNSA's paper mentions, renewable electricity sources are already creating competitive tension for the pricing of gas distribution networks already. By just shortening asset lives, the price for using gas distribution networks will only increase further under the regulatory framework and potentially price them out of the market. Ensuring there are viable uses for the network in the future will ensure there is ongoing pricing tension and therefore choice into the future will be one of the single biggest drivers for ensuring energy remains affordable.

- *Energy affordability for consumers.* As has been demonstrated in recent plans submitted by gas distribution networks to the AER, there are billions of dollars in gas distribution network assets still to be depreciated – or returned to the service provider. To accelerate that depreciation profile will only mean one thing: today's consumers will have to pay more for energy, thereby putting pressure on the affordability of energy. To compound this issue however, for electricity networks to be able to accommodate the increased demand that will arise as a result of gas consumers transitioning to the electricity network, and to ensure that electricity can be provided reliably to this increased demand set and to present day electricity consumers, significant investment will be required to be made by electricity networks and generators. This too will come at a significant cost for consumers. And this doesn't take into account the cost to consumers of having to convert their gas appliances to electricity appliances. As noted in the recent report prepared by the Grattan Institute[7], the cost of switching an existing house from gas to electric stoves, hot water systems and heating systems is up to $20,000 on average. . No cost benefit analysis appears to have been undertaken which takes into account these whole of life cycle costs and benefits.

- *Optimised – reliability at value for customers*. All network businesses talk about a future use for the network with natural gas being replaced by renewable gas over time. They are investing in research and develop opportunities to prove the technical capability of both a blended network (blended with natural gas and renewable gas) and a purely renewable gas network. While this is being done by network businesses throughout the world, it will take time but, as we have seen with the electricity generation system, it has taken time for reliable, renewable electricity generation to replace non renewable electricity generation in a way that is economic for consumers. But the value for customers has not just been driven by industry, it has required support from government. In the case of renewable electricity generation, this has occurred through the establishment of government subsidies and rebate schemes to make renewable electricity more affordable, thereby creating demand for the product which, in turn, drives the pace of technological change and improves the cost competitiveness of renewable generation. Presently, renewable gas is not economic. However, internationally, there are signs that the cost is reducing. This has only come about with government support. However, with the cost of renewable electricity falling sharply (largely because of the level of government support that has been given to the industry over the years), it is even more important that governments also look to ways in which it can further support the renewable gas sector to make it more affordable and so that Australia's energy system remains optimised.

However, it may well be that the way in which these networks continue to play a role will vary from one jurisdiction to another if governments adopt different policy positions. This is beginning to bear out in Australia, as highlighted above.

AGNSA's future of energy networks paper – Attachment 9.6

AGNSA has attempted to generate discussion on the issue of the future of energy networks, in particular gas networks, as the Australian economy transitions to a net-zero carbon emissions future through the preparation of Attachment 9.6 that it submitted to the AER as part of its Revised AA Proposal[8].

The paper primarily focuses on how to determine what changes might need to be made to depreciation profiles to meet the challenges faced by gas networks in a decarbonising economy and more competitive energy sector. While AGNSA has not proposed any changes to the status quo with its depreciation profile in its Revised AA Proposal, it is of the view that the status quo in respect of asset lives is unlikely to remain fit for purpose for much longer.

[7] Grattan Institute, Flame Out – the future of natural gas, November 2020, Appendix D
[8] AGNSA Revised AA Proposal Attachment 9.6 – Future of Gas, January 2021

It is also noted that the AER has included it in its strategic work priority for 2020/21 but it too appears to be focusing on it in the context of "depreciation profiles, focussing on intergeneration equity and stranding risks".

While a more strategic engagement process on this issue is sensible (rather than just dealing with it in the context of 5 yearly access arrangement reviews), we believe that the engagement must consider the issue of the future of distribution networks more broadly than just in the context of asset lives and depreciation.

AGNSA's paper does touch on the issue through other prisms than just asset lives and depreciation but, it doesn't explore the issue in detail – it simply states that the value of the services provided by gas networks in future energy markets, even unconstrained by regulatory pricing, may be less than the efficiently-incurred cost of investments made today under an environment without competition and suggests that this may have profound consequences for regulatory frameworks as currently practised.

The issue is more than just about depreciation

While we appreciate that the AER is limited to working within the statutory framework of the NGR and NGL, we believe that the issue of the future of gas networks needs to be considered more broadly than by asking either what can be done about it under the NGL and NGR or even how to address the issue in the depreciation profiles of a revenue proposal.

AGNSA's paper opens the door on this discussion in section 3.1 of its Attachment 9.6 by stating that a number of factors need to be considered.

However, we believe that government must play a central role in delivering solutions. For example:

- In the case of networks where the government has an ownership stake – such as is the case with Evoenergy – governments could look to writing down the value of their investments in the network. This could be addressed in the existing provisions of the NGR by the government shareholder in Evoenergy proposing that some of the assets are classified as redundant assets, therefore removing the requirement to continue making a depreciation allowance for those redundant assets. This will mean that costs for consumers are managed. To the extent that renewable gas becomes viable and demand on the network begins to increase, these assets can be returned to the capital base at that future point in time and the government is therefore able to resume earning a return of its investment.

- In other cases, there needs to be consideration given to the types of assistance schemes that have been developed to encourage renewable electricity generation and the take up of these emerging technologies and assess how similar support should be provided to networks and the alternative energy sources that could use these networks (such as hydrogen and biogas).

4. MT BARKER EXTENSION

The AER DD approved the inclusion of capex associated with the extension of the network to Mount Barker but noted that it was awaiting confirmation from AGNSA about whether this project was progressing and accordingly, it indicated that it would make a final determination once additional information is provided by AGNSA prior to the final decision.

In its Revised AA Proposal, AGNSA advised that it has decided not to proceed at this time with the extension project to Mount Barker. While AGNSA contends that will reduce the value of the capital expenditure to be added to the capital base by around $60m, it has also impacted on the demand forecast that has been included in the Revised AA Proposal.

AGNSA's primary stated reason for not proceeding with the extension project is that the regulatory framework currently does not deliver sufficient returns on new investment to finance such a significant extension of the network. It states that the marginal returns on discretionary capital expenditure are extremely low, and as a result:

- proceeding with the project will have a negative effect on AGNSA's balance sheet; and
- the proposed rate of return on the capex for this project can no longer meet AGNSA's equity-holders' opportunity cost of capital given other investment opportunities available internationally with a similar risk profile.

While we accept that it is a fundamental principle of the third party access framework for gas pipeline systems that ultimately it is the decision of the service provider as to whether it is economic to fund an extension or expansion of a covered pipeline system, there does not seem to be sufficient reasoning or evidence provided by AGNSA to rely on the above statement as its justification for not proceeding with the extension project at this current point in time.

We would encourage the AER to explore the basis for AGNSA's statement in more detail. This is so, particularly in light of the following:

- In 2018, AGNSA obtained an advance determination from the AER that the capex associated with this extension project meets the new capital expenditure criteria in Rule 79 of the NGR. The issue of the adequacy of the return was not raised at that point in time and the framework for the setting of the rate of return has not changed in that time.
- Rates of return have only changed by 1.24% in 8 years since the first rate of return guideline was established under the NGR. The indicative rates of return that were published by the AER with each version of its guidelines are as follows:

Rate of Return instrument	Overall rate of return	Change since last instrument
2013	5.76%	N/A
2018	5.36%	-0.40%
AER DD - 2020	4.52%	-0.84%

- The new capital expenditure and rate of return provisions of the NGR were reviewed by the Australian Energy Market Commission in 2018 as part of its review into the scope of economic regulation applied

to covered pipelines[9]. At no point in time was the issue of the adequacy of these provisions relating to covered extensions raised by any stakeholder (although it was raised in the context of speculative investments that did not meet the conforming capital expenditure criteria).

- The adequacy of the rate of return on investments has been debated for many years for energy networks but has become more settled in recent years through the development and application of the rate of return guidelines framework. At no stage has AGNSA suggested that the rate of return is inadequate to fund investment, discretionary or otherwise.

- The rate of return framework in the NGR is designed to ensure that it is set at a rate that reflects the prevailing conditions in the market for funds. If AGNSA has evidence to back up its claim that its shareholders can invest their funds in other opportunities with a similar risk profile to the Mt Barker extension project, this should be used to support the case for a change to the rate of return in the rate of return guidelines.

- While the level of the rate of return being proposed for this 5-year plan is lower than the level of the rate of return allowed in the current 5-year plan that is due to expire:

    - The lower rate of return is consistent with the trend in cost of capital globally; and

    - The key reason for the reduction is the cost of debt has decreased and is forecast to decrease. But even then, because of the trailing average cost of debt, the actual cost of any additional debt that AGN would be required to secure to partly fund the Mt Barker extension project would probably be lower than the cost of debt allowance being allowed in the 5-year plan[10]. So, AGN would be afforded a higher average cost of debt in the regulatory rate of return than what it will most likely be charged for the actual debt funding for the Mt Barker extension project.

There also appears to be an inconsistency in approach by AGNSA. Why does it appear to be appropriate for AGNSA to proceed to incur expenditure on other capital programs of a similar magnitude to the Mt Barker extension project (such as mains replacement programs) and therefore be prepared to earn a return on these categories of expenditure at the regulatory rate of return, but not so for the Mount Barker extension project for which the same return was to be allowed?

The reliance by AGNSA on this justification for not proceeding with the Mt Barker extension project creates a dangerous precedent that discretionary investments to either grow or maintain the network will no longer be funded by the service provider when the level of the rate of return is low (relative to historical levels) due primarily to the value of the market derived parameters.

[9] AEMC, Final Report – Review into the scope of economic regulation applied to covered pipelines, July 2018, section 7

[10] See Figure 1 of Attachment 10.2 to AGNSA's Revised AA Proposal, p4

5. FINANCING ISSUES

Rate of Return

It is noted that in the Revised AA Proposal, AGNSA proposed an average rate of return of 4.16% during the AA period, calculated as follows:

	FY2021-22	FY2022-23	FY2023-24	FY2024-25	FY2025-26	Average
Return on debt	4.62%	4.27%	3.92%	3.56%	3.21%	3.92%
Inflation forecast	1.95%	1.95%	1.95%	1.95%	1.95%	1.95%
Risk-free rate	0.86%	0.86%	0.86%	0.86%	0.86%	0.86%
Equity beta	0.6	0.6	0.6	0.6	0.6	0.6
MRP	6.10%	6.10%	6.10%	6.10%	6.10%	6.10%
Return on equity	4.52%	4.52%	4.52%	4.52%	4.52%	4.52%
Rate of return	4.58%	4.37%	4.16%	3.95%	3.73%	4.16%

While we acknowledge that these are placeholder values and it would be expected that the return on debt component for AGNSA would differ from the return on debt component for Evoenergy (given the adoption of the trailing average approach to the cost of debt), the same does not extend to the estimation of:

- inflation forecast;
- the nominal risk free rate (other than as a result of adopting different averaging periods); and
- the return on equity

Yet there appears to be differences as summarised in the table below:

RoR Parameter	AGNSA Revised AA	Evoenergy Revised AA
Nominal Risk Free Rate	0.86%	0.91%
Inflation Forecast	1.95%	2.37%
Return on Equity	4.52%	4.57%

We would expect both Revised AA Proposals to adopt the same values for the above parameters in the final decisions for AGNSA and Evoenergy (except as a result of the businesses adopting different averaging periods for the purposes of estimating the risk free rate – which information we are not privy to). This is so for the following reasons:

- both businesses have proposed to apply all aspects of the rate of return guidelines;
- both businesses have adopted the methodology for estimating inflation as outlined by the AER in its December 2020 decision document; and
- the access arrangements for both networks are proposed to commence at the same time – ie 1 July 2021.

The AER should be encouraged to ensure that consistent values are applied to the above parameters in both Access Arrangement final decisions.

Financeability

AGNSA's Revised AA Proposal again raises the issue of the financeability of the smoothed revenue path. This was also raised in its Original AA Proposal.

It is noted that the AER did not specifically address this point in the AER DD.

AGNSA contends that the AER DD, if implemented in the final decision, would deliver a Funds from Operations (FFO) to debt ratio of 7.9%, which does not meet the threshold of 9.0% that ratings agencies would expect of a business with the credit rating assumed in the AER's Rate of Return Instrument. AGNSA then contends that if the cash flow generated from reference tariffs is not sufficient to maintain the assumed credit rating, the cost of its debt funding will increase in the future. If cash flows are insufficient, AGNSA claims that other measures would need to be taken to increase cash flow, for example changing the classification of spending from capex to opex.

With the Revised AA Proposal, AGNSA contends that it would, if implemented in the final decision, deliver a FFO to debt ratio of 9.6% which reflects what the ratings agencies expect in order to maintain the credit rating assumed in the Rate of Return Instrument.

No further information is provided in the supporting submissions to substantiate these claims.

As we outlined in response to AGNSA's Original AA Proposal, we would expect the AER to test this and to focus on a number of factors, including:

- The extent to which other revenue earned by AGNSA is factored into this assessment (in addition to reference service revenue) – eg revenue from the application of any incentive mechanisms.
- The tax treatment to be adopted in this analysis – noting that "FFO" is revenue less opex and tax.
- How AGN's actual financing arrangements are structured.

In addition to the above, AGIG has explained to us in an information session held on 10 February 2021 that the primary reason it had chosen to include the cost of renewable sourced UAFG as a step change in its operating expenditure forecasts (rather than to allow for this to be dealt with in the tariff variation mechanism) is to ensure the financeability of the business. We have not been provided any evidence to support this approach and again, we would urge the AER to test this. There would not appear to be a compelling case to warrant a change in approach from the current access arrangement. This is explored further in section 7.

6. CAPITAL EXPENDITURE

This section of the report focuses only on the mains replacement capital expenditure included in the forecast of capital expenditure.

While the AER DD accepted that mains replacement is justified on the grounds that it is necessary to maintain and improve the safety of services and to maintain the integrity of services, the AER reduced the program spending by $50 million due to:

- deferring 115km of AGNSA's proposed 520km of block replacement of low pressure CI/UPS mains and modifying the unit rate proposed for the North Adelaide mains replacement program;
- deferring 48km of AGNSA's proposed 198km high pressure HDPE 575 DN40 mains by insertion to prioritise replacement of mains laid prior to 1991;
- deferring the whole program to replace 90km of HDPE 575 DN40 MP mains by direct burial until the 2026-31 AA period, as the AER concluded that data does not suggest an ongoing or recurrent problem with respect to squeeze off failure in this category.
- The AER also modified the unit rate proposed by applying a 10% discount to the schedule of rates and modified the proposed unit rate for the non-AMRP service replacement.

The AGNSA's Revised AA Proposal did not accept all aspects of the AER DD relating to mains replacement and supported its revised proposal with a report from GHD which concluded that a prudent operator would:

- seek to replace all remaining low pressure mains including cast iron and unprotected steel mains in the network; and
- seek to replace 198 kilometres of HDPE 575 DN40 high pressure mains laid up to 1993; and
- not defer the replacement of CI/UPS mains into the subsequent AA period as more recent failure data (up to November 2020) shows the condition of these mains continues to deteriorate.

Given the additional information supplied by AGNSA and that it has been supported by external expert advice relating to its need to be undertaken to ensure the safe operation of the system, we would support AGNSA's revised approach in relation to mains replacement capex. However, we believe that it would be appropriate for the AER to make enquiries of the local safety and technical regulator (the Office of the Technical Regulator) to confirm that there is a sound safety based justification for undertaking the proposed mains replacement program.

7. OPERATING EXPENDITURE

We note that AGNSA's forecast of operating expenditure is $351 million, which is $21 million (or 6%) higher than the allowance in the AER DD but $7 million (or 2%) lower than AGN SA's Original Revised AA Proposal.

The key reasons for the $21m increase from the AER DD are:

- Step Changes – AGNSA has maintained its original Plan position on the 3 step changes – i.e., the digital experience, the Vulnerable Customer Assistance Program and higher insurance costs – they are retained (increase by $8m);
- UAFG - AGNSA has accounted for the forecast cost of purchasing renewable gas (as part of meeting its UAFG requirements) as part of the opex forecast, instead of incorporating these costs in the annual tariff variation mechanism (increase by $1m);
- Base Year opex – AGNSA has updated the base year opex for 2019/20 actuals (increase by $7m); and
- Input price growth methodology - The trend applied to AGNSA's base year costs has been updated to use a real labour escalation forecast derived from an average of the most recent forecast from BIS Oxford Economics and the Deloitte Access Economics forecast used by the AER in its Draft Decision (increase by $5m).

In relation to the base year opex update to now include 2019/20 actuals, we would encourage the AER's consultant to test the step increase of $7m.

We comment on each of the other increases in turn in this section of our report.

Input price growth methodology – labour price growth

We also note that in relation to the approach to the forecast input price growth rate outlined in the Revised AA Proposal, AGNSA has not adopted the approach followed by the AER in the AER DD. In that decision, the AER adopts a lower forecast lower input price growth rate (-0.1%) compared to that proposed by AGNSA (+0.6%) because the AER has changed its approach in two respects:

- to only use data from Deloitte's real Wage Price Index growth forecasts and
- to only use the most up to date forecast of growth in the utilities WPI (as opposed to the average of WPI growth forecasts).

The AER justifies these changes in approach from its standard approach on the basis that the Deloitte index is more accurate and because the most up to date forecast factors in the full economic impact of the COVID–19 pandemic. However, in the AER DD, the AER did state that if AGNSA submits updated forecasts that account for the changed economic outlook as a result of COVID-19, the AER may reconsider using the AER's standard approach in the final decision.

AGNSA's approach in the Revised AA Proposal has rejected the approach outlined in the AER DD and continued with its approach in the Original AA Proposal – i.e., using an average of multiple utility WPIs – the Deloitte and BIS Oxford Economics utility WPI forecasts for South Australia. This is because, according to AGNSA:

- both indices factor in the full economic impact of the COVID-19 pandemic as at December 2020;
- an average is likely to produce more accurate projections and therefore is a better forecast;
- using averages is consistent with what the AER does for electricity networks in relation to output escalation, return on debt and assessing relative opex efficiency.

We would support the use of an average of multiple indices in circumstances where each index does not suffer any inherent flaws. This is particularly important where the building block involves the estimation of a forecast.

Step Changes - Vulnerable Consumer Assistance Program (VCAP)

In the AER DD, the AER noted that while AGN's customer engagement found there was genuine support for these projects, the AER did not consider including the costs of these initiatives as a step change was sufficiently justified. However, it did note that the AER would give further consideration to including the vulnerable customer assistance program initiatives as a category specific forecast if AGNSA provides further information showing the project would materially increase the quantity or quality of services provided.

In the Revised AA Proposal, AGNSA has retained the forecast costs of the VCAP initiatives in its forecast operating expenditure as a category specific forecast (approx. $0.75m pa for each year of the AA period).

The initiatives are:

- the establishment of a dedicated vulnerable customer service role within AGNSA;
- the development of a priority services register using the upgraded Customer Relationship Management (CRM) system; and
- the provision of funding:
    - for gas appliance safety checks and emergency appliance repairs for AGNSA's vulnerable consumers; and
    - to help vulnerable consumers access more efficient appliances.

This was explored further by AGN with stakeholders at a workshop held on 4 December 2020.

While as a matter of principle, we support genuine and coordinated initiatives that are aimed at supporting the most genuine customers, we raise a number of issues in respect of the proposal.

Firstly, before any additional set of initiatives are launched, we think a process should be undertaken to review all of the existing support initiatives for vulnerable consumers and identify:

- the extent to which they are appropriately targeted and giving the best support for vulnerable consumers – whether that be in terms of financial support, operational support and energy efficiency support;
- to the extent that there are any gaps, what initiative should be introduced to best address that gap;
- which stakeholder in the customer journey chain is best place to provide each of the initiatives. It appears to us, given the plethora of existing support initiatives that have been developed by a range of stakeholders, that to date, the process has been adhoc and not strategically targeted to properly address the real needs of vulnerable consumers;

By adding more initiatives to an already "crowded field" of initiatives may not result in the best outcome for vulnerable consumers.

The second issue we raise is that the AER requested further information from AGN to demonstrate how these initiatives would materially increase the quantity or quality of services provided. While AGN has provided a detailed submission with further information (attachment 7.2A), the further information provided by AGN contains only some information to demonstrate how the initiatives would materially increase the quantity or quality of services to be provided. Instead, the further information mostly outlines:

- how the initiatives don't double up on other programs already in place to address hardship and social sector support;
- the extent of stakeholder support for the initiatives. It would be important for the AER to gauge directly from stakeholders who attended the session on 4 December whether they actually did support the retention of these initiatives; and
- how the program should be funded.

The presentation from the 4 December workshop outlines three options that AGNSA considered and with option 3 being the proposed (and preferred) option. However, what is not apparent is whether AGNSA considered an option that contributed towards the enhancement of existing initiatives in place by retailers and governments, for example, the extent to which some of the initiatives can be incorporated into the retailer energy productivity scheme (which replaced the retailer energy efficiency scheme on 1 January 2021).

The third issue is that it is still not clear why these aren't initiatives which are better managed by retailers given retailers are likely to be approached directly by vulnerable consumers (who would be seeking tariff relief in most instances). Further information should be sought in this regard from both AGNSA and retailers.

The fourth issue is that the VCAP program does not yet appear to be scoped out in detail. The submission included with the Revised AA Proposal recognises that the program is a first of its kind and therefore, AGN intends to work with retailers and other interested parties in trialling and refining the program in the first 18 months. If it is still unclear what is going to be in the program for the first 18 months, then at least for the first 18 months, it may be prudent to reduce the level of forecast expenditure to zero for that period. Alternatively, it may be more prudent to allow a reduced amount to fund a proof of concept initiative and then assess its effectiveness before expanding the trial. This may be a more prudent approach given that this program is acknowledged to be a first of its kind.

Finally, if an amount is to be included for these initiatives, this should not be covered in the ECM mechanism because it could well incentivise AGNSA to underspend.

Step Changes – digital customer experience

The AER DD did not approve AGN's proposed Digital Customer Experience (CRM) (totalling $4m) either as a step change or a category specific forecast for a number of reasons:

- it was not satisfied the additional opex is required to deliver additional online services to customers.
- that the proposed service improvements are a refinement of services AGNSA currently provides and is consistent with gradual improvement of good industry practice rather than as a step change.
- the AER does not consider the step change to be material and could be compensated through the forecast rate of change.

AGNSA's Revised AA Proposal continues to propose the opex costs associated with the Digital Customer Experience Project ($4m) as a step change. In justifying this position, AGNSA did not consider that this step change will be appropriately compensated for through the forecast rate of change for the reasons outlined in section 1.4.3, which includes the contention by AGNSA that it is already absorbing other opex cost pressures of around $4m.

Based on the information provided in the Revised AA Proposal, we are unable to conclude that this initiative would be more than just a service improvement, rather than a step change. It would be assumed that AGNSA already has a sophisticated customer engagement system given the need to make regular contact with consumers and for that engagement to be face to face given the operational nature of the engagement required.

Also, as is the case with the VCAP initiatives, it is not clear the extent to which any of the initiatives being proposed to enhance the customer experience are not already offered by other stakeholders in the customer journey (eg retailers) or whether they are being appropriately targeted. Moreover, AGNSA's additional information doesn't explain how the initiative in the project all amount to a distinct uplift in services for all customers rather than a refinement in existing services.

UAFG Allowance for renewable gas

The AER DD did not allow the inclusion in the forecast opex of the cost of up to 20% of UAFG being purchased using renewable gas. However, instead, the AER stated that AGNSA can already purchase replacement gas from renewable sources in accordance with the preferences of its customers and recover this through the tariff variation mechanism in the access arrangement.

Notwithstanding this, the Revised AA Proposal does include the forecast cost of purchasing renewable gas as part of meeting AGNSA's UAFG requirements and has included an amount in its forecast opex rather than recovering it through the tariff variation mechanism. AGNSA's primary reason for including these costs in the operating cost forecast are not stated in the submissions accompanying the Revised AA Proposal. However, at an information session held with the ECA and AGIG on 10 February 2021, it was stated that AGNSA has changed its approach primarily to ensure financeability of the business.

While the unit price for renewable UAFG might be largely known, the amount of UAFG that is to be required in any given year is not necessarily largely known. It would therefore seem to be in the interests of consumers to only pay for something once the cost is known. This is consistent with one of the ECA's objectives that consumers don't pay any extra for energy any earlier than they have to. Given that the tariff variation mechanism includes a time value of money adjustment in it, the service provider is not prejudiced. This would also facilitate the operation of the ECM.