3rd February 2016

Mr Warwick Anderson
General Manager
Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
CANBERRA ACT 2601

By email to: ActewAGL2015GAAR@aer.gov.au

Dear Mr Anderson,

Re: AER's Draft Decision on ActewAGL Access Arrangement

Thank you for the opportunity to make this submission to the Australian Energy Regulator (AER) regarding its draft decision of 26th November 2015 and ActewAGL's revised proposal of 6th January 2016 for the Access Arrangement for 2016-2021.

New Connections

Our key issue is the rate of connections to the gas network in the future. ATA welcomes the AER's intervention on Core's unrealistic assumption that 90% of new homes will connect to gas.

The AER's draft decision looked to historical trends and updated the assumption with 62%[1] (page 14). Given our research findings documented in our original submission (and expanded on below), we have reasonable doubt that gas connections will continue into the future at anything like historical rates.

We agree with the statement by ActewAGL on page 26 that:

> *"it is in consumers interests to have the best possible demand forecasts as they ensure that consumers pay no more or less than necessary for our services. "*

It is therefore surprising that ActewAGL fail to engage with the substance of our argument, merely noting in their responses that they **don't agree** that "gas is no longer competitive in the ACT" (p146).

Our research identified in detail the current economics and future trends of gas versus electric appliance choices for ACT households. We therefore ask on what basis does ActewAGL reject our findings? Are there specific aspects of the modelling or research that ActewAGL disagree with?

Our work unequivocally found that new connections to the gas network are uneconomic in the ACT:

> *"New consumers connecting to gas will not be served with the most cost effective energy supply and existing consumers will experience higher bills as they subsidise new connections. As noted above, once the new assets are built, the cost to finance and maintain them is recovered from all consumers."*
> AWSCWG p34

[1] AER, Draft Decision ActewAGL Distribution Access Arrangement 2016 to 2021 Attachment 13 - Demand, November 2015

As we noted in our August 2015 submission, ActewAGL reports that its own customers are similarly challenging growth of the gas networks:

> *"It is important that current customers do not subsidise new customers, or that existing customers are not burdened with the cost of paying for long-term infrastructure that is for the benefit of future customers. "* (ActewAGL, 'Attachment 1: Consumer Engagement' p19)

> *"Keen to ensure the long-term viability of ActewAGL and don't want to see us invest in infrastructure that may be obsolete in the long-term future. Questioned if the growth of the gas network, by increasing the number of customers, the right long-term strategy?"* (ActewAGL, 'Attachment 1: Consumer Engagement' p19)

Given the above, ATA questions how ActewAGL can then assert the following:

> *"Connecting new customers shares fixed costs across a greater number of consumers and is therefore in their long term interest"* (page 25)[2].

In this context, ATA also considers the following statement grossly inappropriate and of little relevance to the long term interest of consumers:

> *"New economic connections have always been the foundation of our business's success and become even more important as natural gas competes more aggressively with other fuels."* (page 47).

Official Residential Gas Demand Forecasts – Historic Trend Based

At issue is the extrapolation of historical trends to future gas demand, both of connection rates and per connection usage.

To be clear, forecasting is not objective science. Subjectivity comes in the choice of a time period (for example last 3, 5 or 10 years) and choice of method for extrapolation (for example, linear or exponential).

Another subjective choice is whether to forecast underlying demand then build up the impact of differing market drivers, which requires disaggregating those forces from the observed historical data series. These are some of the subjective choices to be made when forecasting.

ATA welcomes the AEMO's National Gas Forecasting Report published in December 2015, although it too relies on "backwards looking" forecasts for residential gas demand. This report advances the sector's understanding of the impact of different factors in reducing gas demand per connection.

These factors include energy efficiency improvements, drought (impacting on water consumption and hot water demand) and the Global Financial Crisis (which led to the home roof insulation scheme). AEMO continues to apply historical trends to connection rates.

In reviewing Core's forecasts for the AER in South Australia, consultants ACIL Allen said it "recognises that forecasting on the basis of extrapolation of historical trends involves a risk of overlooking changes in market drivers that could result in future trends differing from historical trends[3]." These issues are well understood, even if the techniques for addressing them are underdeveloped.

[2] ActewAGL Distribution, 'Response to draft decision 20 16 – 21 access arrangement', January 2016.

[3] ACIL Allen Consulting, Report to the Australian Energy Regulator - Review of Demand Forecasts for the AGN South Australia Gas Networks for the Access Arrangement period commencing 1 July 2016 – Public Version, 11 November 2015, page 37.

Demand forecasts are required to be reasonable. ATA's submission in August 2015 suggested that consultants should have to justify their gas demand forecasts with reference to the economics of the appliance choices facing households, including different fuelled technologies. Core Energy failed to do this.

Based on our research, reasonable questions of a "trends based" forecasting approach would be:

- How many households would be newly connecting when it is an uneconomic choice for them?
- Why would households do this?
- What is the assumed or implied long-run market share of more cost effective technologies (e.g. efficient electric) and what take-up rate is implied?
- What proportion of forecast gas demand could be attributed to market failures[4]? (What is the downside risk to forecasts if governments choose to redress market failures, for example in response to the Paris Agreement to limit global warming to 2 degrees since the pre-industrial era?)

ATA maintains that history is not the best guide to future residential gas connections and gas demand.

ATA's submission argued that this practice, which contributes to the AER's draft decision, is not consistent with the planned and equitable contraction of the gas network that is likely to be required.

We reiterate from our original submission the request that businesses intending to expand gas networks into new housing developments are subject to a Regulatory Investment Test – just as electricity networks are for asset replacement. This is to ensure the expansion is indeed in the long term interests of consumers.

As part of this process, the suite of technology and fuel choice options available to consumers must be properly considered.

[4] Market failures, include:

- Information barriers – it is difficult for a reasonably informed citizen to access reliable information about comparative running costs and ownership costs of appliances of different fuels. People tend to make decisions based on advice from friends and family and received wisdom says that mains gas is a cheap fuel source.
- Split incentives - landlord/tenant. With the structure of the Australian tenancy system, tenants do not have any control over appliances in the house. The tight rental markets limits the scope for prospective tenants to choose housing based on energy running costs, even if that information was available. Furthermore the short term leases that characterise much of the Australian rental market reduce tenant's time horizons. Whereas homeowners may rationally choose to replace a gas space heater with reverse cycle air conditioners if the expected cost savings were within 5 years, tenants would not.
- Split incentives- builder/owner. If builders building 'on spec', without specific buyers in mind, they may be motivated to put the cheapest appliances into a residential building - gas.
- Split incentives - plumber/owner. When it comes to hot water, plumbers are more familiar with gas appliances. It might be easier for them to recommend those products (gas) with which they are most familiar.

These market failures are described and documented further in the context of heat pump hot waters in Commonwealth of Australia (2013), Equipment Energy Efficiency E3, Consultation Regulation Impact Statement: Heat Pump Water Heaters, July 2013. Page 10

Required Rate of Return

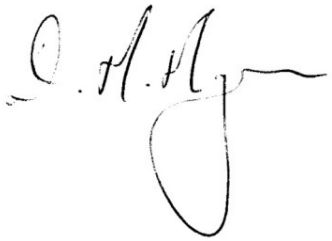
As with SA, we note the required rate of return is the major contested issue.

ActewAGL's revised proposal of 6th January 2016 boosts the proposed rate of return of 8.58%, up from 7.15% in their original proposal. The AER's draft decision was 6.09% and ATA expects that the lower WACC will be the final decision of the AER.

ATA also wishes to underscore that ActewAGL's shareholders and bondholders should have always made past investments with an understanding of all the risks (e.g. declining demand from a more efficient competitor being electricity and carbon constraints).

Thank you for the opportunity to submit to this process and should you have any queries, please do not hesitate to contact either Kate Leslie on kate.leslie@ ata.org.au or myself on 03 9639 1500.

Yours sincerely



Damien Moyse
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