Energy Consumers Coalition of South Australia

A response to the Australian Energy Regulator Draft Decision on Australian Gas Networks AA2016 Revenue Reset

DEVELOPED BY THE ENERGY CONSUMERS COALITION OF SOUTH AUSTRALIA, AN ASSOCIATE OF THE:

Major Energy Users Inc.

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February 2016

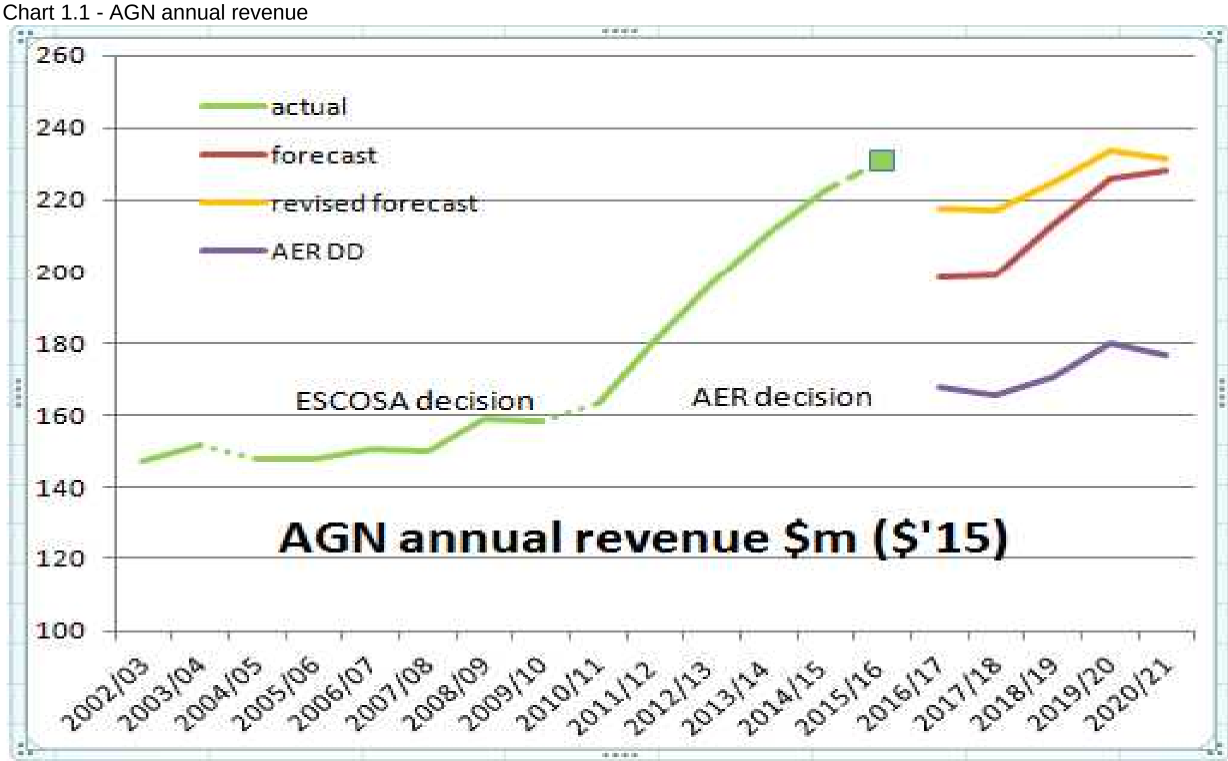
Executive Summary

The Energy Consumers Coalition of South Australia (ECCSA) welcomes the opportunity to provide its review of the Australian Energy Regulator (AER) Draft Decision of the Australia Gas Networks (AGN) Access Arrangement SA gas distribution application for the AA2016 revenue reset.

The ECCSA welcomes the reductions in revenue allowed to AGN for this reset period. We view this approach, generally, as prudent and appropriate when assessing current market conditions. However, the ECCSA does not agree with all the AER's findings. These are outlined below. That AGN has elected not to accept the AER draft decision in its entirety means that AGN seeks higher revenue than that allowed in the AER draft decision and, indeed, higher than its initial proposal.

The following chart outlines revenue allowed for the past 3 reset periods proposed for the AA2016 and the draft decision of the AER for this period. At the same time ECCSA sees that the amounts of gas transport capacity[1] sold by AGN has fallen by nearly 20% over the past 15 years and is forecast to fall even further over the next 5 years. Effectively, gas consumers are paying more and more for less and less.

Chart 1.1 - AGN annual revenue



Source: AGN RIN data, AGN initial and revised proposals, AER DD, ECCSA analysis

[1] This is the capacity sold to tariff D customers plus the volume of gas sold to Tariff V customers

We note the significant upward spike in allowed revenue for the AA2011 period. The ECCSA is of the view that, broadly, this sharp increase should have off set or mitigated large increases for the AA2016 period. Yet, what we see, inclusive of significant reductions in some key areas of the draft decision, is this trend being maintained.

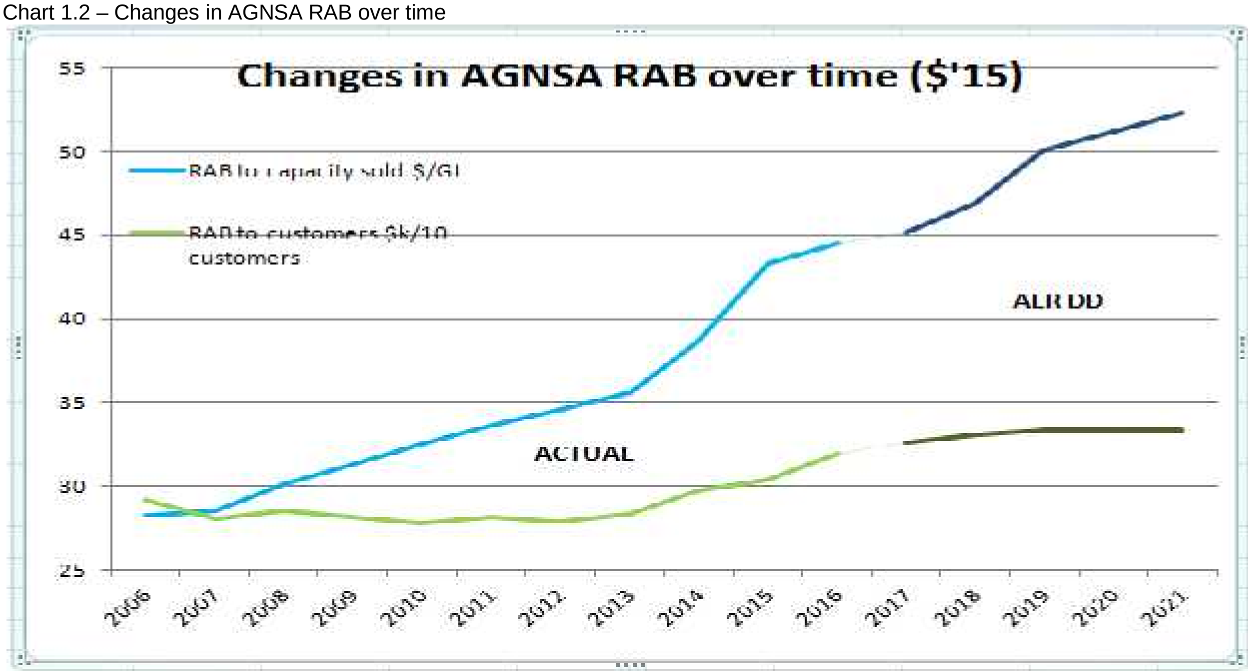
We appreciate the limitations of the AER in their ability to curb market factors that influence this alarming trend. However, we view this as a key issue for South Australian consumers and one that must be addressed.

The causes and concerns for these increases in the current period and that being currently assessed were discussed in our previous submission. However, the ECCSA would like reassert our concern on the impact on the high capex program that was initially proposed by AGN. Thankfully, the ECCSA notes that the capex program was the most significantly reduced area of AGN's proposal in the AER draft decision.

That AGN would consider their initial and revised proposals acceptable only suggests that they have not got consumer interests in mind. Indeed, we note that their proposed capex program is compounded by a previously large capex program of the current period. Again, we wonder where future costs have been mitigated by these past programs.

The ECCSA wishes to again reassert findings provided in our past submission that assess the volumes of gas transported vs that of the impacts of capex program on the regulatory asset base.

Chart 1.2 – Changes in AGNSA RAB over time



Source: AGN RIN data, AGN initial proposal, AER DD, ECCSA analysis

This chart has been updated with allowed capex revenue outlined within the AER draft decision. What is concerning is that, despite the significant reductions within the AER decision on capex proposed by AGN are the massive amounts of capital provided to deliver less and less amounts of gas to consumers. What is also important to note is that each customer is paying for an ever increasing value of assets despite using less and less gas.

It is the firm view of the ECCSA that this trend is unsustainable, unjustified, and unfair to all consumers.

Moreover, the initial AGN proposal, inclusive of the reductions within AER draft decision, maintains this trend. A trend that, the ECCSA highlights, only serves the interest of the AGN shareholders, and not that of the consumer.

Whilst we disagree on some of the positions held by the AER, and some of the reasoning behind their allowances, we view the draft decision as positive step in tackling these continued increases in revenue sought by AGN, and view them as in the best interest of the SA gas consumer.

An issue of major concern

ECCSA notes that the current risk free rate (the 10 year CGS) is currently about half its long term average (ie about 300 basis points lower than the average). This is having a major impact on the perception of the AGN proposal and the AER draft decision. If the risk free rate was at the long term average, the ECCSA considers that the revenue and the resultant notional tariff would be exhibiting increases rather than the reductions shown.

While current consumers welcome any reductions in tariffs as a result of the lower 10 year CGS, ECCSA is concerned that as a result, there is less pressure on trying to ensure that the fundamentals of the various costs (eg growth in RAB, capex, opex, etc) are not being addressed as needed.

A return to the long term average value of the 10 year CGS will impose considerable cost on future consumers as the price of the service will be considerably higher than is implied as an outcome of the artificially low 10 year CGS.

Essentially, the current low rate masks the impacts of an excessive and unnecessarily large opex and capex program.

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1. Introduction

1.1 The ECCSA

The Energy Consumers Coalition of SA (ECCSA) is a forum representing large energy consumers in South Australia. The ECCSA is an affiliate of the Major Energy Users Inc (MEU), which comprises more than 20 major energy using companies in NSW, Victoria, SA, WA, NT, Tasmania and Queensland.

The ECCSA welcomes the opportunity to provide comments on the AER's Draft Decision on the South Australian AGN Access Arrangement gas distribution pipeline system.

1.2 The scope of this review

This review will provide comment on the AER draft decision on the AA2016 AGN revenue reset and make reference to the AGN revised proposal. The ECCSA is concerned that the AER draft decision has not delivered an outcome that is in the long term interests of consumers and, as the AGN revised proposal increases the costs that consumers will be required to carry, the ECCSA is more dissatisfied with the revised proposal.

This review will commence by providing a summation and overview of the interrelation of these areas, and that of the AER draft decision. It will then provide a greater level of detailed analysis and commentary on key areas of the draft decision.

The ECCSA will also provide a focus on areas that were initially discussed in its original submission to the proposed revenue for the AGN AA2016 access arrangement, whilst also providing comment on findings by the AER. The absence of comment does not necessarily indicate support in these areas by the ECCSA and comments made in the earlier submission are still relevant.

1.3 Summary of recent developments

In the response provided to the AER on the AGN proposal, the ECCSA highlighted that this reset review is undertaken at time subsequent to a previous set of rules that were overtly incentivising investment. The recent rule changes and the AER Better Regulation program was aimed at reducing the incentives for investment to more acceptable levels.

In addition, the ECCSA would like to highlight that this review is being carried out not long after a sale process by the AGN. That AGN was sold for a significant premium over the Regulatory Asset Base (RAB) is indicative of a view that regulation is not as efficient as might otherwise be the case.

The ECCSA reasserts its concern that regulatory revenue reviews under the AER may have lost sight of the objectives of network regulation, which are to service the long-term interests of consumers.

Gas (and electricity) prices remain on the rise, with what appears to be no end in sight. Many of these increases are substantial and well above inflation, placing an ever increasing burden on the end user. AGN continues to propose significant increase in tariffs as highlighted in the AA2011 of 25%, and again in this latest review of AA2016.

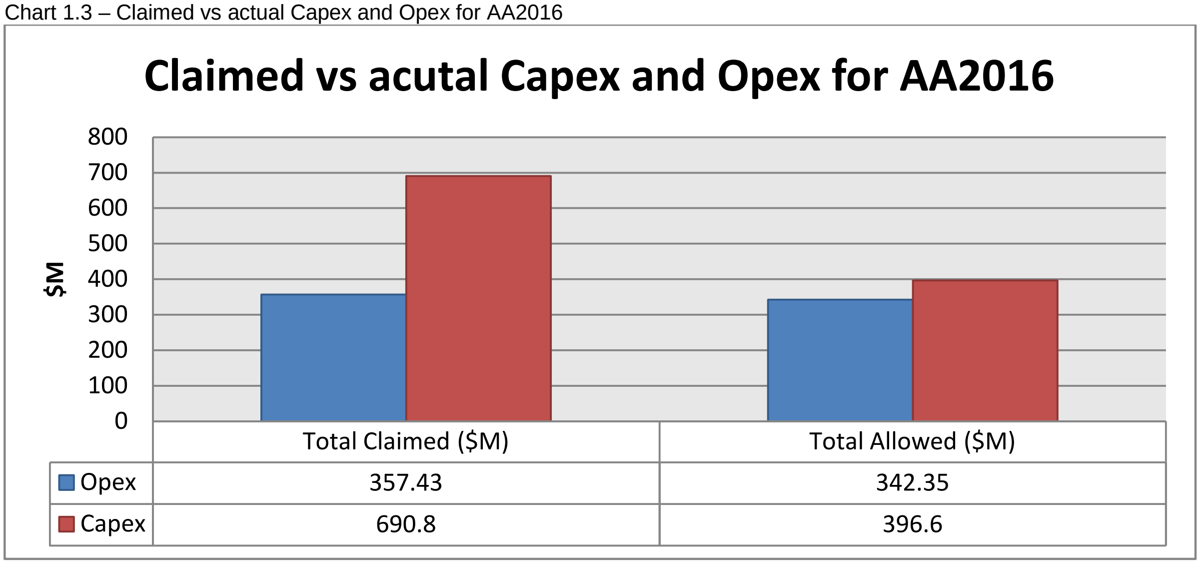
The ECCSA considers that the network price increases that arise out of the proposals and draft decision are not in line with the current market conditions and only serve to place a significant burden on the consumer. The ECCSA acknowledges, however, that the AA2016 does in some areas reflect a limit in increases. Yet, concerning, the AGN proposal indeed provides for significant and unwarranted increases in many other areas. It is quite clear that these increases are not in interests of the consumer, and that consumer interests will only be recognised appropriately by implementing a much more significant cost cutting approach across all areas of the proposals.

ECCSA further notes that AGN is proposing to reduce tariffs in the early years of the next period, although ECCSA highlights that tariffs in real terms later in the next period are even higher than those that apply now. However, with the continuing growth in the RAB (despite being offset to some extent due to lower costs of capital than apply in the current period) and falling consumption, the ECCSA finds it difficult to reconcile any revenue growth with the lower consumption forecast.

1.4 An overview of the AGN application and the AER draft decision

The AGN's proposal forecasted significant revenue which ensured massive increases for this reset period. This revenue sought by AGN was compounded by a significant increases in revenue approved in the prior reset period by the AER, as highlighted in the graph below.

Chart 1.3 – Claimed vs actual Capex and Opex for AA2016



Despite an 18.2% overall reduction allowed by the AER in revenue sought by AGN as highlighted in the chart above chart, the ECCSA maintains concerns with some of the methods utilised by the AER, as well as some key areas identified by the ECCSA that were not included in their response, to assess their decision. These areas are discussed in detail below.

A notable area of reduction with the revenue sought by AGN lies in the capex with the AER draft decision for an allowance of some $294M as opposed to the $690.8M originally sought from AGN. The ECCSA welcomes this and encourages the AER to maintain this view as it develops its final decision. However, the decision by AGN to only reduce marginally the capex request in the revised proposal does little to address the massive impact on the ever increasing RAB.

The ECCSA does not welcome, however, the regrettably marginal difference in opex claimed and opex allowed for this period. The ECCSA has provided a number of key points in its prior decision, which it will again revisit in this report, that we believe justify further reductions in opex for the coming reset period.

The ECCSA would also like to note that the AER Draft Decision uses a lower Rate of Return (RoR) which reduces revenue sought by the AGN. However, the ECCSA will would like to highlight, again, their concerns on the use of RoR within their Draft Decision which will discussed in more detail below. ECCSA also notes that AGN has rejected the AER draft decision on WACC and has increased its WACC requirement in its revised proposal, which increases the WACC to 8.19% compared to their initial proposed WACC of 7.23%. Concerningly, it is clear that the revised proposal is crafted so that AGN will benefit from any moves by the Competition Tribunal away from the AER WACC guideline.

The ECCSA noted in its submissions to the reset review for AA2011, that it was very concerned at the rise in revenues being contemplated, particularly with regard to the amount of capex proposed. The ECCSA welcomes the 44% reduction in Capex sought by the AGN allowed by the AER. However, the ECCSA identifies that the bulk of this reduction stems from not approving AGN's proposed mains replacement expenditure, (a decision which we support). Yet, the ECCSA has concerns that the AER has not taken into consideration prior comments made by the ECCSA relating to Capex sought, specifically:

- AGN attempting to minimise the effect of a step increase in revenue on the basis that the actual revenue was less than the amounts allowed by the AER

- AGN's costs tended to be much less than the regulator allowed so that the less than expected revenue was offset by the benefit of the opex and capex under-runs

- That the AER assess the increase in revenue AGN is seeking in its revised proposal but with lower gas capacity sales compared to the new tariffs which are forecast to decrease - this appears inconsistent,

Moreover, although the ECCSA welcomes most of the reductions proposed by the AER, it still holds some concerns over key areas identified with the initial ECCSA submission to the AGN proposal that have not been implemented in the draft decision provided by the AER.

1.5 The helicopter view

The ECCSA welcomes the 18.2% reduction in revenue initially proposed by the AGN and further reduced by the AER draft decision. However, the ECCSA maintains key concerns over important elements of left out of the draft decision that we feel are pertinent to this review. These areas will be discussed in greater detail below, however, in summary:

- The validity of the AGN stakeholder engagement program in appropriately representing consumer views

- Despite some reductions in allowances to the capital base of $14.6M or 1.0% less than proposed by AGN there was no incentive during AA2011 on capex to drive costs to the efficient level. ECCSA considers that asset benchmarking has revealed that AGN is not the most efficient in asset provision and this, in turn, provides a view that AGN capex practices are probably not at the efficient frontier.

- The ECCSA supports the reduction to $342M in allowed opex, (a 4%, reduction) for the reset period, although we view this reduction as significantly understated. We further support the AER decision to focus on the 3 key areas of Category

Specific Forecasts, Rate of Change and Step changes. However, the ECCSA is of the view that key points made by our organisation need to be recognised, including:

- Past history of AGN forecasts of opex have been much higher than the allowances granted, indicating that AGN/Envestra has a serial trend to over-forecast its opex needs.
- There is an overall increasing trend in operating and maintenance (O&M) costs
- There is a further underlying concern in that AGN has a consistent bias to over-claiming its opex allowance and then under-running it. On past performance, it is a reasonable assumption that the claimed opex for the next period is also overstated.

- It has been insufficient that there are no defined service performance standards explicitly set so that consumers can see what service performance is provided for the price set by the regulation of the monopoly service provider. The ECCSA welcomes the recent decision by the Essential Services Commission of South Australia (ESCOSA), on the service standards that will apply to AGN in the 2016–21 access arrangement period

- The ECCSA supports the view determined by the AER that the contingent nature of AGN's proposal to use an accelerated depreciation model is incomplete and underdeveloped and the view that it should not be implemented during this reset period

1.6 Consumer engagement

The ECCSA welcomes the view of the AER when they state that "informed decision making under the NGL and NGR"[2] is important. The ECCSA further supports the view held that effective consumer engagement provides "confidence" in the network's processes and sets a minimum standard for regulatory practice.

The ECCSA acknowledges the work undertaken within the Better Regulation program and its design to be more inclusive and provide an opportunity for consumers to be engaged and provide input. ECCSA also acknowledges the AER assessment on the additional processes AGN undertook in relation to stakeholder engagement.

However, the ECCSA would like to reassert that, despite the above; stakeholder engagement is not consumer engagement. This is an important distinction for a number of key reasons:

- Stakeholder engagement cannot be consumer engagement as it encompasses the views on parties not responsible for payment of the services. Moreover,

[2] Pg 8 - AER draft decision – Overview: Australian Gas Networks.

stakeholders will have varying motivations for being engaged with this process, as opposed to a consumer, whose core reason for involvement will be to reduce network costs to the efficient level while maintaining acceptable service levels

- Some of the conclusions drawn from the AGN Stakeholder Engagement process directly support AGN claims. We are concerned this is a direct result of potential consumer 'leading' within these processes. Direct involvement by consumers in network engagement practices shows that networks do not (and possibly cannot in the time made available by AGN) provide sufficient information to enable definitive conclusions to be drawn[3]

- The ECCSA reaffirms its view supported by the Consumer Challenge Panel on 'Willingness to Pay' as outlined within their original submission

Most importantly, the ECCSA wants to reassert its concerns that AGN has based their decision to implement a number of key projects on the basis of feedback from consumers. This point leads back to the strong claim on the disparity between stakeholder engagement as opposed to consumer engagement.

Our view is that, in many respects, stakeholders may enter into this process with an inherent bias as opposed to that of a direct consumer. Indeed, representatives of the ECCSA have noted on many occasions that there is the potential for some stakeholders to 'cost shift' from their own organisational costs to energy consumers through "stakeholder" engagement.

This is of significant concern, and an area that the ECCSA feels it important to consistently reassert. A central theme from the AGN consumer engagement process is AGN seems to have missed is that it is consumers that pay the increased costs associated with enhanced services and not the other stakeholders that AGN consulted with. It is easy for non-paying stakeholders to agree to increased costs because they don't have to pay for them!

We assert, again, our position that it is unacceptable for the AGN to claim a willingness to pay on key projects as a result of consumer engagement, when indeed relevant consumers might not have been engaged.

We are pleased to note that the AER, and as a result AGN, have accepted that there are areas of change required for AGN consumer engagement programs going forward. The ECCSA support this position and would welcome the opportunity to be involved in this process.

[3] In this regard, ECCSA agrees with the assessment made by the AER CCP subpanel 3 about consumer engagement in the Victorian electricity distribution review (see report available at http://www.aer.gov.au/system/files/Consumer%20challenge%20panel%20-%20Sub%20panel%203-f)

Finally, the ECCSA would again like to reassert their agreement on the Consumer Challenge Panel Report, which stated:

> *"The considered view of CCP3 is that consumer engagement can provide some guidance to a DNSP, but cannot be deterministic, due to the many issues that surround the various approaches that are being used."*[4]

1.6.1 ECCSA conclusions

As noted in our original submission, ECCSA sees there is considerable merit in AGN engaging with the consumers that utilise the network services it provides. Equally, ECCSA considers that the engagement carried out so far does not provide AGN with substantiation, at this stage, for AGN to claim that consumers are willing to pay for additional services. This view is clearly supported by the observations of AGN that it is "stakeholders" (eg as stated in sections 7.3 and 8.3 of the AGN proposal) that concur with the AGN views rather than consumers providing support.

As noted above, although the ECCSA is happy that the AGN is trying to increase the effectiveness of their consumer engagement programs, we view there is still a significant way to go. In addition, we find claims of consumers welcoming increased flow on of costs from AGN programs baffling, given the current financial pressures experienced by businesses and households.

We further assert that given the excessive increases in gas costs over the past years (with more to come), consumers do not have the appetite for more increases in network costs. These financial pressures experienced by the consumer have only have clear result – that of the need to reduce costs, and not see any subsequent increases. Our view is that much of the consumer engagement program only supports the intent of AGN and their aims for the coming reset period where network costs are reduced.

1.7 Summary

It is the view of the ECCSA that the AGN proposal was excessive in some key areas and this view still applies to the AGN revised proposal. However, the ECCSA further identifies that the AGN had placed some effort in ensuring that areas of their reset proposal were more balanced and reflected some consumer interests. Regardless, although the ECCSA is not of the view that the proposal was balanced, ECCSA recognises that AGN has tried harder this time to engage consumers in the reset process compared to previous reset reviews.

The ECCSA welcomes the AER's draft decision and the reductions in revenue allowed for the AGN. The ECCSA moreover supports these reductions, however is of the view

[4] Page 9 - CCP3-%20Response%20to%20proposals%20from%20Victorian%20electricity%20distribution%20network%20service%20providers%20-%205%20August%202015_1.pd

that further reductions are still required in light of the ever increasing RAB and the long term impacts that this will have on future consumers.

It is essential that regulatory price reviews do not lose sight of the basic fact that if the regulator keeps on allowing increases in capex and opex, the prices the networks will charge for providing an essential service will take the cost of gas beyond the ability of competitive industry and many consumers (especially disadvantaged consumers) to pay.

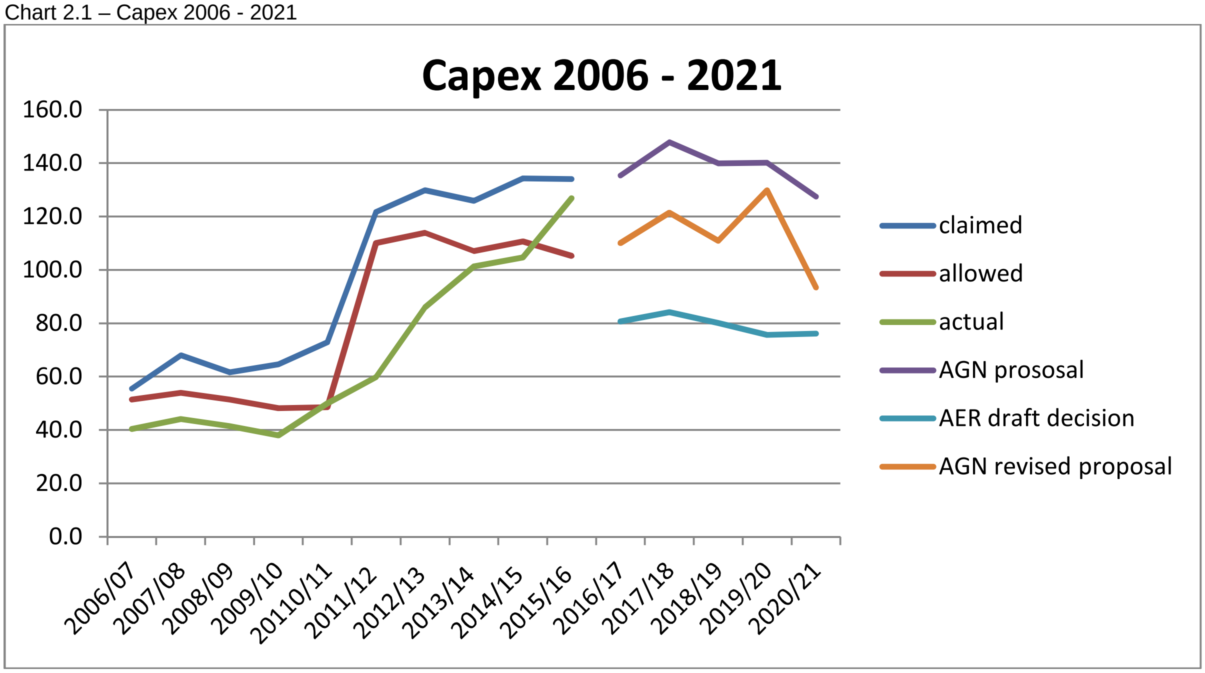
The rules for regulating networks have been changed significantly since the last AER review of AGN (then called Envestra) and these give the AER much more discretion in the exercise of its role. The new rules also place much more weight on benchmarking of performance and use of the benchmarks to inform what efficient costs are.

In the following sections of this report, the ECCSA will provide comment on the areas of revenue reduction, and retention outlined within the AER Draft Decision. We will also provide further commentary on areas that are notably absent from the draft decision that were highlighted in previous submission work by the ECCSA.

2. Capital Expenditure Allowance

The ECCSA welcomes the 44% reduction in capex allowed to AGN by the AER draft decision for this AA2016 period. The ECCSA is of the view that this decision is in the best interests of the consumer and adequately reflects the appropriate amount of capex sought for this period. The ECCSA encourages the AER to maintain this position during the remainder of this review process.

Chart 2.1 – Capex 2006 - 2021



The ECCSA further supports the AER's decision to base this reduction on underspends within the AA2011 review. We view this as a pragmatic and effective manner in which to base decisions of this nature, and that reflect taking consumer interests into consideration. We are delighted that the AER considered positively the views expressed by the ECCSA in its submission to the AGN reset when it stated:

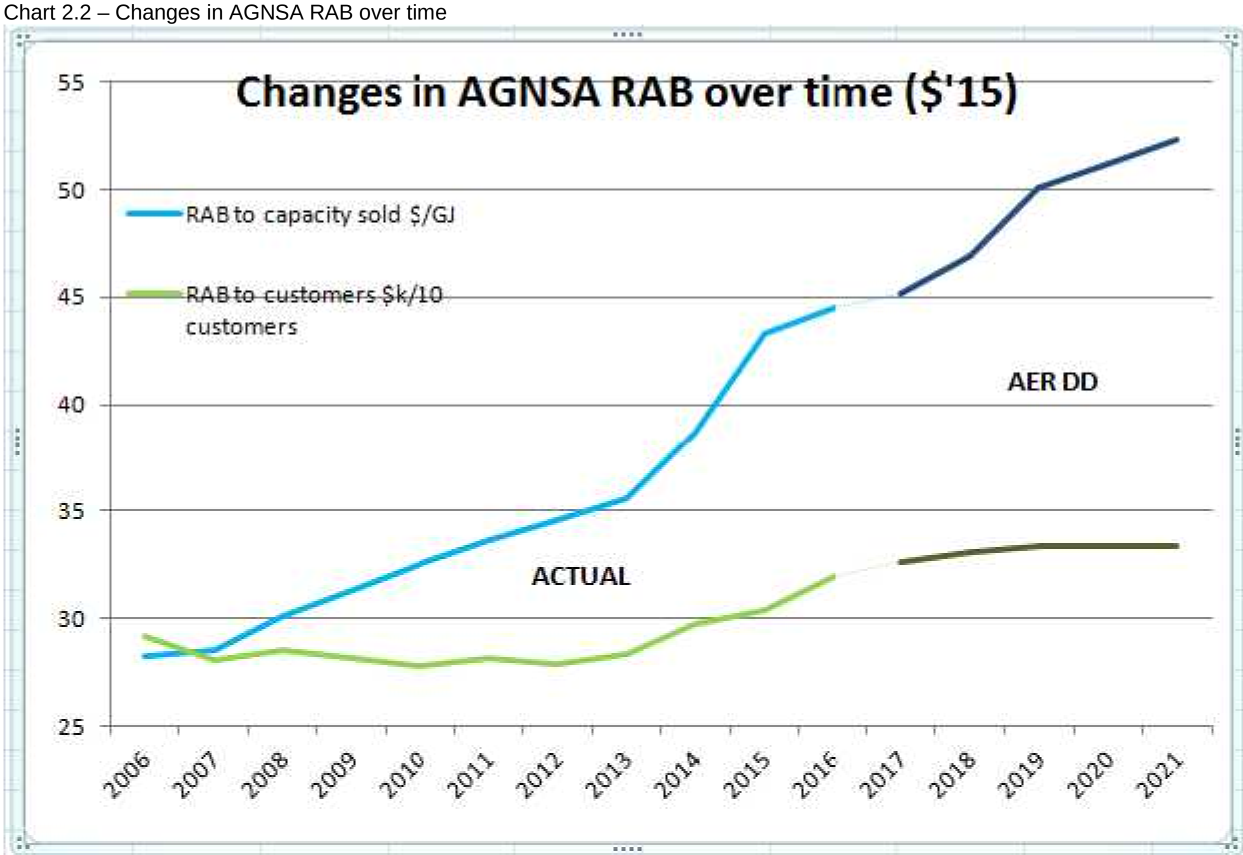
"The ECCSA considers that the AER needs to address recurrent activities and use historic needs for capex to inform on what is reasonable to carry forward into the new period"[5]

There are, however, some areas of the capex sought that the ECCSA provided comment on which were not reflected in this current draft decision. One key area of this is the manner in which AGN used their consumer engagement program to justify their increases which we discuss below.

[5] Page 27 – ECCSA response to SA Gas Distribution Revenue Reset

As an over-riding concern, one key area that the ECCSA views is of significant importance is that of the consistent increases in the AGN RAB when related back to the basic controls of gas capacity and numbers of customers. The graph below outlines the changes in AGN RAB over the past decade. What we note from the RIN data is that load factors of demand customers is 50-60% which indicates that the volume customers capacity can have been accommodated with the unused capacity paid for by demand customers, implying that AGN could be "double selling" some of the same capacity.

Chart 2.2 – Changes in AGNSA RAB over time



Source: RIN Data, AER DD, AGN proposal, ECCSA analysis

This chart highlights two key issues:

1) The value of the assets used to provide for gas transport when related to actual capacity sales[6] has increased by nearly 60% over the last 10 years with the bulk of the increase occurring in the current regulatory period. The AER draft decision continues this massive and unsustainable escalation in the value of assets used to transport gas by 85% increase over 15 years. This growth in RAB in relative terms is unsustainable and transfers to future consumers an unacceptable long term and unnecessary cost premium.

[6] Capacity sales comprises the MDQ sold concerted to annual amounts of capacity with the volume of gas sold to volume customers

2) The value of assets used to provide gas transport based related to customer numbers has increased by over 10% over the past 10 years and the AER draft decision continues this trend. This means that the new connections are not prudent as existing customers are paying more for the new connections than the increased connections return. A prudent new connections policy would result in the cost of the asset/customer falling over time. Further, as the asset base is massively increasing when related to the amount of gas transported, this reinforces the conclusion that the new connections are not providing a net benefit to existing customers and therefore the new connections are not prudent.

In its proposal, AGN has sought approval for a number of significant capex claims. As part of its proposed capex program it consistently asserts that its stakeholder engagement program gives support for the proposals. ECCSA comments on the use of the stakeholder engagement program are detailed in section 1.6 above.

The ECCSA feel that it is, again, important to note that the average amount of capex in AA2006 was $43m pa, during AA2011 it was $96m pa (a 125% increase, more than doubling the previous capex), and proposed for AA2016 is $140m pa, a further increase of 46%. Against this backdrop of capex increases is a falling consumption of gas, reducing the utilisation of the AGN network. However, while we see that the AER draft decision is a slight reduction in the AA2011 actual capex, it is still nearly twice the level of capex seen as needed in AA2006. The AER draft decision is a trend in the right direction, but is still too high when compared with capex needs seen over the longer term than just the last 5 years.

2.1 Expansions and augmentations

Table 2.1 – Augmentations

Category	Proposed	Draft Decision	Difference
Augmentation($M)	17.9	4.1	-13.9

Table 2.1 above highlights the AER draft decision on Capex for expansions and augmentation. The ECCSA welcomes the proposed reduction and views it as a prudent measure for this capex sought. The ECCSA would further like to support the AER position for this decision when they state

" the AGN has not provided evidence in the form of rigorous (quantitative) risk assessment to demonstrate that the proposed capex is conforming over the 2016-21 access arrangement period that complies with rule 79"[7]

We agree with the AER's position to exclude the Southern Transmission Pipeline (SA21) and Murray Bridge (SA71) projects as unjustifiable for the 2016-21 access arrangement period. Additionally, we would like to note the findings of AER consultant, Sleeman Consulting, who argued that the Southern Transmission Pipeline will remain "fit for purpose" and which threshold levels are below that require capital works. The

[7] Page 6-9 AER Draft Decision - Capital expenditure: Australian Gas Networks

ECCSA assumes that the AGN was aware of this but still sought to include this unnecessary work as a way of increasing their capex for this period. Further, it is important to note that these “unnecessary” costs would ultimately pass through to the consumer and place an increased burden on them, a position evidently not considered by AGN

The ECCSA, however, would also like to note key areas outlined within their original submission in relation to augmentation that were not discussed within the AER draft decision that we believe warrant closer inspection:

- The price of gas as a commodity has increased dramatically over the past 5 years, which places significant pressure on consumers. Any capex sought from AGN should be considered from this perspective. This position is supported by the Alterative Technology Association (ATA) who argue that it is not prudent to continue to expand gas networks, due to the release of more efficient and cost effective electrical appliances becoming available

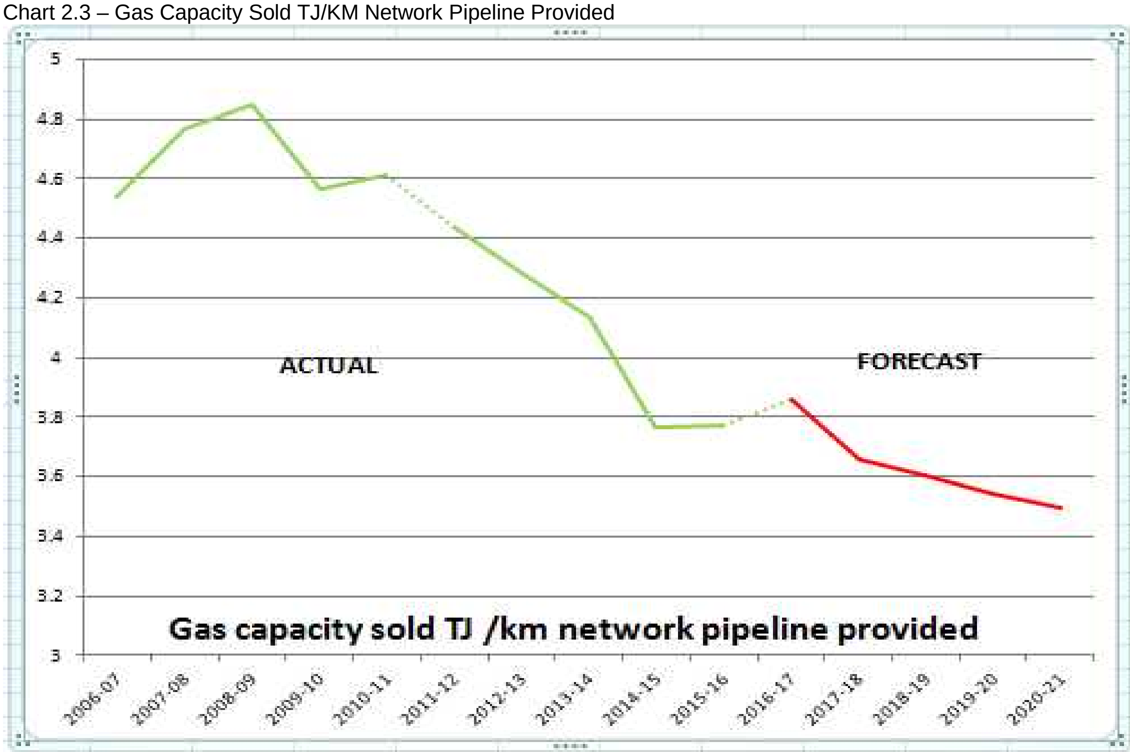
- The above research brings into question any capex sought from the distribution networks, and places a significant onus on the networks to evidence without a shadow of a doubt the need for any capex required.

- Capex sought to expand networks should provide a reduction in costs to consumers; however, as evidenced in the below graph, we have continually seen utilisation of the gas networks fall significantly over the past decade and projected going forward. This is concerning and evidences that an abundance of capex sought that can be argued is only in the best interest of the distribution network owner and not that of the consumers

- AGN does not provide any evidence that the costs to existing consumers and future consumers will fall as a result of the expansions and augmentations or, at worst, return a zero benefit. This assertion is supported by the AGN who state that new customers want these expansions; however, what is absent from the assertion is any calculations to support that this is the case when all of the costs are included. It is important to note that while new consumers might see value in access to gas supplies, would they be so sanguine about being connected if they were responsible for all of the costs involved. By AGN socialising a significant amount of the costs, this provides a distorted view on the real cost for these new connections. Whilst ECCSA supports the connection of new customers, the connection should only be carried out when the connection provides a net benefit to all customers. It is inappropriate that existing customers should fund new connections that increase costs to existing customers.

- Further, AGN asserts that it needs to augment the network to increase capacities. Firstly, ECCSA points out that the replacement program of the CI and UPS mains would increase capacity. Secondly, the utilisation of the networks is falling dramatically as the foregoing chart shows.

Chart 2.3 – Gas Capacity Sold TJ/KM Network Pipeline Provided



Source: RIN data, AGN proposal, ECCSA analysis

The declining amount of gas capacity sold relative to network length highlights that augmentations are not necessary. It also provides a view that expansions might not be commercially viable too.

The ECCSA notes that in the current period, AGN underspent its allowance significantly in relation to new connections. ECCSA considers this is a direct result of consumers increasing concern about the rising cost of gas and the availability of more efficient alternatives. ECCSA sees this trend continuing (even increasing) as the cost of gas increases even more so[8].

Despite this, ECCSA notes that the AER has generally agreed with AGN about the numbers and costs associated with growth of the network. ECCSA is not convinced that in an environment of rapidly increasing gas commodity prices and the falling amount of gas used at each residence, there is an economic case supporting the ever increasing numbers of residences connected to the gas network. Indeed, as discussed previously, this position is compounded by the rise in new efficient technologies that further impacts gas used. We strongly view that it is incumbent on AGN and the AER to ensure that the new connections are demonstrably economically efficient.

[8] ECCSA members report that the cost of gas in 2017 will be more than 40% more than the cost in 2014.

ECCSA notes that in its revised proposal, AGN restates its view that expansion of the network provides a benefit to existing consumers through amortising the fixed costs over an increased number of consumers resulting in a lower cost per customer. While the ECCSA agrees that this is a laudable aim, the actual costs of the expansions undertaken have not resulted in a reduction of costs for other consumers. ECCSA has demonstrated this through the charts showing a declining use of capacity relative to the length of the network and the increasing value of RAB relative to the number of customers connected.

2.2 Mains replacement

Table 2.2 – Mains Replacement

Category	Proposed	Draft Decision	Difference
Mains replacement ($M)	369.9	167.7	-202.2

The ECCSA welcomes the AER's draft decision on the AGN's capex sought in relation to mains replacement. The ECCSA further welcomes the significant reduction in capex allowed by the AER in this regard and highlights that this is a key area within the draft decision that ensures a an overall reduction in the AGN proposal, and ultimately, the cost to the consumer both now and in the future.

We agree with the AER's position that the capex sought within this area by the AGN is not "prudent or efficient"[9], nor do we view that the AGN's use of identifications of 'hazards' to be used as a basis on which an issue 'may' occur and that it 'may' have a significant impact.

The ECCSA would like to reassert that the first element of the mains replacement program, which focuses on the replacement of the CI and UPS mains, has been now ongoing for close to a decade. It is the view of the ECCSA that this program should now have been completed, and consumers should be seeing a benefit from this investment. In this regard, it is not clear whether the opex savings (eg the cost of repairs when a leak occurs) has been identified and built into the opex allowance. ECCSA considers that the forecast opex should include a benefit from the impact of this significant capex, especially the capex that was instituted in the last two years of the current period and in the AA2016 period as the project is completed. Indeed, this position is supported by the AER who note higher opex productivity in the last reset period and that they should be expecting to obtain similar productivity growth for the coming period

The ECCSA welcomes the view outlined within the AER draft decision that information in relation to the mains replacement program provided by the AGN does not "establish the actual impact on its network"[10] and therefore did not satisfy the AER in this area.

[9] Page 18 – AER Draft Decision: Australian Gas Networks 2016-2021
[10] Page 34 – AER Draft Decision – Capital Expenditure: Australian Gas Networks 2016-2021

Additionally, in support of this view, the ECCSA stated previously that it considers that the proposed HDPE main replacements are still within their expected asset life and, on that basis, replacement should not be undertaken unless there is a clear business case for such to occur. We support the AER findings that support this position. What is not available to ECCSA is the opex savings that might accrue from the replacement compared to the cost of the replacement.

In its revised proposal, AGN asserts that the replacement of the existing HDPE plastic mains is compliant with their regulatory obligations, and therefore is prudent and in the long term interests of consumers. ECCSA does not necessarily disagree with the fact that AGN might have a regulatory obligation to repair these gas lines but questions whether the wholesale replacement is warranted, and whether it should be a cost to consumers. ECCSA remains convinced that AGN has the responsibility to ensure that the assets that are funded by consumers deliver the outcomes that are expected.

ECCSA does not consider that consumers should effectively be responsible for errors made by AGN (and Envestra before it) in selection of materials of construction or construction techniques. AGN is an experienced gas network provider and should not require consumers to effectively underwrite its poor performance. If AGN was operating in a competitive environment, customers would not agree to pay a premium for the purchases just because AGN had made an error in the selection of its production equipment.

The replacement of leaking mains is the dominant element of the capex program. ECCSA consistently points to the ever increasing value of RAB relative to capacity sold and number of customers connected. Replacement of the mains has marginal impact on the numbers of customers connected or to the falling demand for gas, yet it dramatically increases the RAB which is a driver of the cost of the services provided. The only way to limit the growth in the RAB is to minimise capex, and therefore ECCSA considers that the AER has a significant responsibility to limit the amount of investment of uneconomic asset replacement in the gas network.

2.3 IT program

Table 2.3 – IT Program

Category	Proposed	Draft Decision	Difference
Information Technology ($M)	66.7	37.9	28.8

The ECCSA agrees with the AER draft decision on the reduction in capex sought for the Information Technology (IT) section of their proposal. We strongly agree with the AER's assertion, supported by the Consumer Challenge Panel (CCP) questioning the need for such an extensive program, especially given that it is almost twice that of that sought during the AA2011 review.

Further, with the declining amount of gas being transported, ECCSA questions whether significant investment in IT is warranted. In this regard, ECCSA members advise that with a falling demand for their products, they have significant difficulties in obtaining capex for any activities that either do not increase productivity or quickly deliver outcomes that reduce the costs of production. ECCSA points out that the current IT system is adequate for the service and a change will not increase productivity or reduce costs.

We are delighted that the AER highlighted concerns specifically raised by the ECCSA when we argued that consumers are satisfied with the manner of service as it currently stands, and that the AGN had not effectively argued demonstrated how this program would benefit consumers. Further, the ECCSA reasserts its position, supported by the AER, when it states that these projects should only be approved if they result in a net benefit from opex reduction in less than 4 years.

ECCSA notes that AGN, in its revised proposal, considers that its proposed IT program has a "positive economic value" and will "maintain and improve the safety … and integrity of the services"[11]. There is no evidence provided that sustains these assertions and ECCSA points out that the current IT delivers the required levels of safety and integrity. ECCSA also asks how spending $18m on IT will deliver a positive economic benefit when the current IT systems adequately provide the service required by consumers.

2.4 Regulators and valves

Table 2.4 – Regulators and Valves

Category	Proposed	Draft Decision	Difference
Regulators ($M)	13.6	11.	-2.6

The ECCSA is disappointed in the lacklustre reduction imposed by the AER in relation to Regulators and Valves section of the AGN proposal. Whilst the AER has decided that the AGN proposal in this section warrants such a significant increase, the ECCSA is unconvinced, for a key reason:

- ECCSA considers that replacement of regulators and valves is a recurrent cost issue and not subject to specific unforecasted needs which would support a specific short term need for increased investment.

We would like to reinforce that the value for this step up is an increase in excessive of 100% from their last allowance. In addition, AGN had a significant overspend equating to nearly 100% in this area during the last reset period. What we fail to see here is how this overspend has been translated into this new period, and most importantly how it has benefited consumers.

[11] Page 41 – AER Draft Decision – Capital Expenditure: Australian Gas Networks 2016-2021

2.5 Other distribution system capex

Table 2.5 - Other Distribution

Category	Proposed	Draft Decision	Difference
Other distribution($M)	37.7	10.0	-26.9

The ECCSA supports the AER decision to reduce the capex sought for Other Distribution System Capex to $10M for the coming period. The ECCSSA specifically agrees with the AER's decision that the $25.5M sought for a number of projects have not been allowed and that the 'non-compliant meter installations project's opex and has been transferred to the relevant section.

We are again delighted to note that the AER has utilised concerns raised by the ECCSA when it questioned the need for projects outlined within this section that had already been funded within the previous reset period. The ECCSA finds it incredible, and misleading, that AGN would attempt to "squeeze" more funds for work they have already been granted funds to complete. This approach of deferring investment after being granted funds to carry out a specific task is a bane for consumers and requires them to pay more for the services provided than is needed or warranted. ECCSA has seen AGN (then Envestra) apply this process as standard practice in nearly every reset since deregulation commenced early in the 2000s. It is unacceptable.

2.6 Asset lives used

We note that the AER has maintained a consistent approach to asset lives and regulatory depreciation. The ECCSA supports the AER in this.

2.7 Summary

The ECCSA held significant concerns over the revenue sought by the AGN for this revenue period, as outlined within our initial submission. However, the ECCSA is relieved, moreover, upon the reductions imposed on AGN through this draft decision.

The ECCSA accepts that the AER has been thorough in its assessment of the capex sought by the AGN and has made a determination accordingly. However, the ECCSA would like to reassert the following concerns relating to capex sought with the view that they will be considered during the final determination:

- We do not agree and are incredibly concerned in the manner in which AGN used their consumer engagement program to justify their increases

- The price of gas as a commodity has increased dramatically over the past 5 years, which places significant pressure on consumers. Any capex sought from AGN should be considered from this perspective. This perspective is lacking within the revenue sought.

- The ECCSA would like to reassert that the first element of the mains replacement program, which focuses on the replacement of the CI and UPS mains, has been now ongoing for close to a decade. It is the view of the ECCSA that this program should now have been completed, and consumers should be seeing a benefit from this investment, not another "cash grab" within this reset period.

- We are delighted that the AER highlighted concerns specifically raised by the ECCSA that argued that consumers are satisfied with the manner of IT service as it currently stands, and that the AGN had not effectively argued demonstrated how this program would benefit consumers

- The ECCSA is disappointed in the lacklustre reduction imposed by the AER in relation to Regulators and Valves section of the AGN proposal. Whilst the AER has decided that the AGN proposal in this section warrants such a high value, the ECCSA is unconvinced, for a key reason:

    - ECCSA considers that replacement of regulators and valves is a recurrent cost issue and not subject to specific unforecasted needs which would support a specific short term need for investment.

3. Forecast Operating Expenditure

3.1 Overview of past and future opex

Whilst the ECCSA is pleased to note that the AER states it is not satisfied with the forecast of opex sought by the AGN, we highlight that the AER draft decision has seen only marginal reductions in the opex sought from the AGN, of less than 4% over the reset period. The ECCSA is of the view that much higher reductions are warranted, and which were outlined in the original submission to the AGN proposal. These will be discussed in greater detail below. ECCSA also notes that revised proposal from AGN "has sought to accept[12]" the AER draft decision on opex but then seeks to increase the allowance based on

- a revised (increased) base year opex,
- an updated (increased) forecast for UAFG
- re-inclusion of one step change
- removal of the productivity adjustment

Overall, the revised AGN proposal results in the revised opex proposal being only slightly less than the initial opex proposal

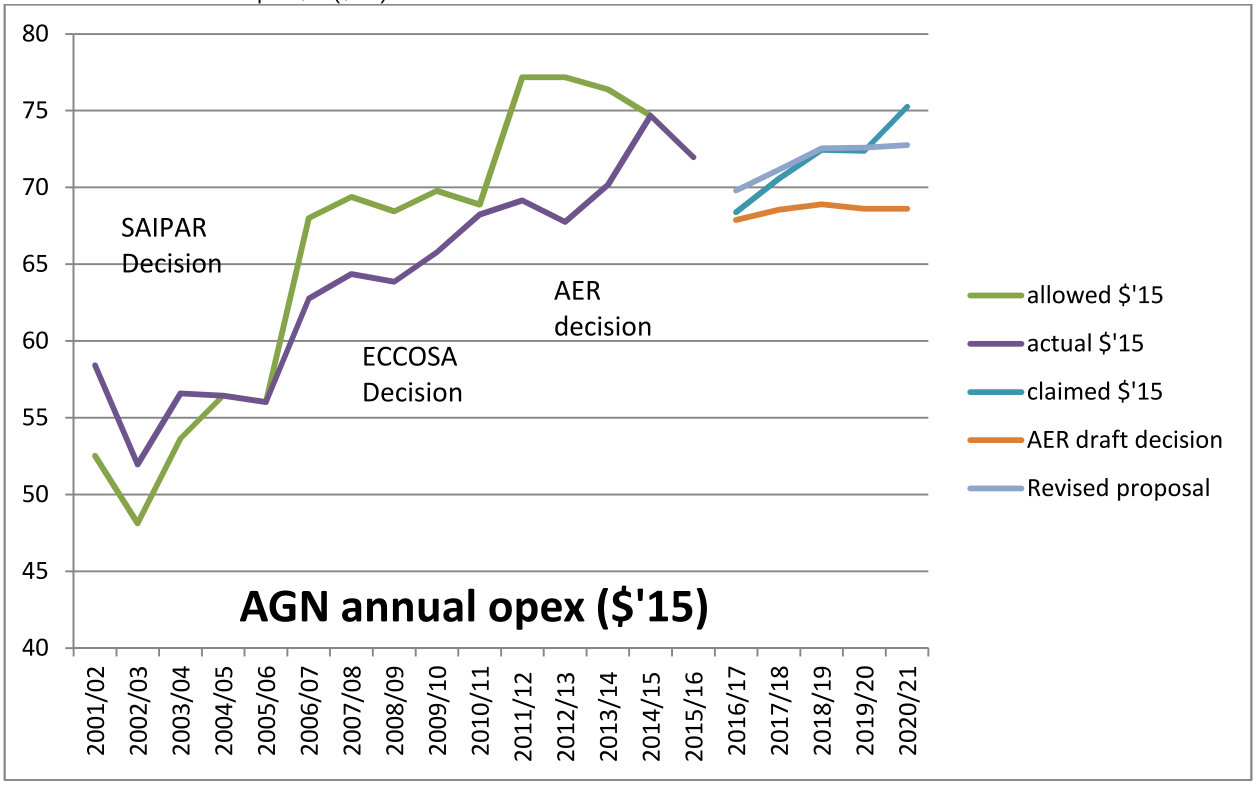
The ECCSA would like to reassert that, despite a small reduction of $15.09M over the reset period, AGN has sought roughly the same average opex it utilised in the AA2011. As highlighted previously, opex in the current period (in real terms) has increased much faster than the size of the network. What we are not seeing, however, is a reflection in terms of the benefits of the significant capex investments over the AA2011 period. Quite simply, the capex sought during this period should have reduced UAFG and maintenance costs through mains replacements; however, we have not noticed a reduction in opex as a result of these works.

ECCSA's basic question is: When will consumers see any benefit from the massive amounts of capex they are paying for? Instead, consumers are seeing the RAB continuing to increase despite falling gas transport capacity being sold and little or no reduction in opex.

In our prior submission, the ECCSA provided an overview on the history of AGN proposal for opex during the reset periods. This is of importance as it clearly demonstrates a history of consistent under-runs and opex sought being significantly higher than allowances granted which are then higher than the opex actually used. This recent draft decision demonstrates a "balancing out" of this trend. The ECCSA welcomes this developed and encourages the AER to keep this trend in mind when assessing all opex for the AGN. This trend is highlighted shown in the following chart.

[12] Page 1 – AGN: Revised Access Information 2016 - 2021

Chart 3.1 – AGN Annual Opex $m ($'15)



The ECCSA acknowledges the key areas of change between the AGN proposed and AER draft decision on the AA2016 and agree with the following points:

- AGN's forecast of price changes, output growth and productivity changes are not the best estimate of a rate of change
- The omission of included forecasted increases in opex relating to step changes
- That the forecasts associated for ancillary reference services, network arrangement fee and insurance do not meet opex criteria

However, ECCSA notes that AGN in its revised proposal an upward increased actual opex for the base year. As the chart shows, the base year opex is the highest amount of opex in the current period. ECCSA questions whether the AER should use another year for the base year as it would appear that AGN could well have transferred opex into the base year in an attempt to overstate the opex needs for the next regulatory period forecasts.

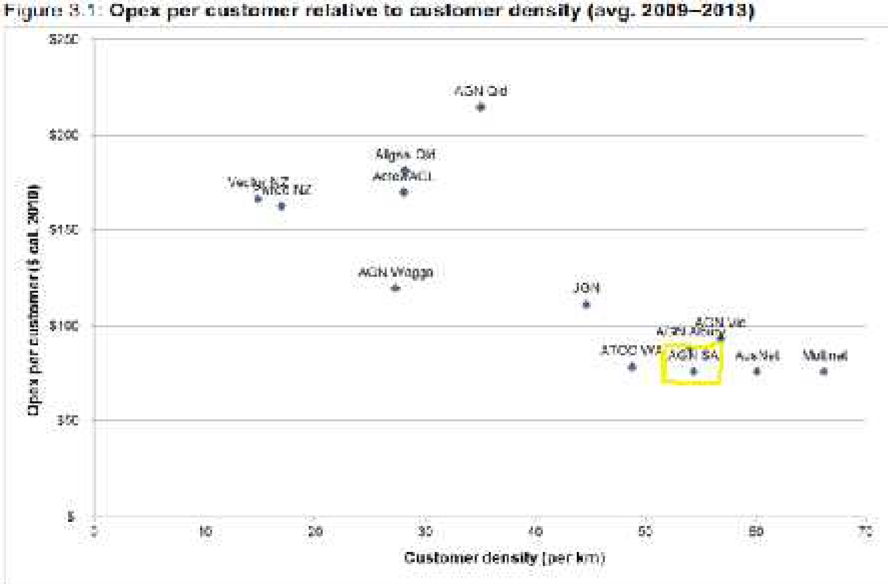
3.2 Benchmarking

The ECCSA notes a concern flagged within its original submission that appears to absent from the AER draft decision. The ECCSA identified a trend within opex sought by AGN over the past 2 reset periods in which overall opex has increased; however, alarmingly, despite the significant capex provided to increase network length, which should have resulted in a greater proficiency of service for consumers, we have not seen this investment off set in the current opex.

However, at least the claimed opex increase in AA2016 is much the same as the increase in pipeline length, implying that the claimed opex increase might be efficient. We are pleased to note the AER draft decision that supports this claim.

Economics Insights has benchmarked AGN opex and provides the following chart to support a view that the current AGN opex might be efficient.

Figure 3.1: **Opex per customer relative to customer density (avg. 2009–2013)**



Source: Economic Insights gas utility database

On a comparative basis, it would appear that the AGN opex is close to the efficient frontier and that the current costs (at least up to 2013) are efficient, however, what is concerning is that there is a significant increase in opex between 2009 and 2013 and the impact of the earlier lower costs would have influenced the average opex used in the benchmarking study. Whilst the average opex for 2009-2013 would indicate that the AGN opex is efficient, this does not mean that the base year is efficient as the base year costs are set at $75m yet the average of the 2009-2013 years is $66m pa. This implies that the base year costs are high by some 14%.

The fact that AGN in its revised proposal has further increased the base year opex makes the ECCSA very concerned that the base year opex is not efficient.

3.3 Base year opex

The ECCSA supports in principle the view outlined by the AER that posits the 14/15 base year expenditure is a reasonable estimate to forecast opex over the reset period and that the AER shares our view that ancillary service costs, management fees and insurance are recurrent costs and should be allowed included within the base year opex.

The ECCSA reasserts its concern that there has not been the significant reduction in the O&M costs during AA2011 that should have occurred as a result of the extensive capital investment into the cast iron mains replacement program. Not only should this program have reduced the amount of UAFG, it should have caused a significant reduction in the opex that would have been needed for attending to the many gas leaks that AGN had postulated were occurring and was a reason for the program being implemented.

The ECCSA reaffirms its view that the AER needs to investigate these issues in more depth.

3.4 Network management fee

The ECCSA reasserts its position that the AGN should have sought competitive prices for the network services (including the management fee) rather than continue with a negotiated service arrangement. The ECCSA is concerned that this issue, which we know is standard practice in a competitive business environment, has not been addressed.

Whilst we could understand the decision of Envestra to have negotiated its operating agreement with its related party (APA Group), the sale of Envestra has eliminated this part ownership relationship that existed with APA Group. ECCSA would have expected that the operating agreement with APA Group would have been put out for competitive tender.

3.5 UFAG

The ECCSA notes that the AER accepts the "considerable uncertainty[13]" surrounding AGN's UAFG expenditure forecast. However, we are very concerned that despite this forecast, the AER has accepted the AGN proposed UAFG amounts as a starting point for the "true-up" proposal. ECCSA notes that the reservations it had regarding UAFG in the initial proposal from AGN have been confirmed in its revised proposal which increases the amount of UAFG expected for the coming period.

ECCSA is concerned about the approach to the true up process. The AER has decided that AGN should take the risk in relation to the volumes of UAFG (and in its revised proposal AGN accepts this) but the cost of the gas will be on the basis of price as

[13] Page 40 – AER Draft Decision – Operating Expenditure: Australian Gas Networks 2016-2021

incurred. ECCSA considers that while there is merit in this approach, it also imposes no pressure on AGN to secure the lowest possible price for the gas. Indeed, the providers of the gas will be aware that AGN will accept any price for the gas as it allows, effectively, a price pass through for the gas acquired. ECCSA finds this unacceptable if there is no requirement on AGN to find the lowest price for the gas. For example, ECCSA considers that there needs to be independent benchmark prices set as a comparison rate for assessment of the price pass through, such as the average of the Adelaide STTM spot price annualised. AGN should be incentivised to secure gas at a lower price by sharing (say 75% to consumers 25% AGN) for any savings below the benchmark.

With regard to the other leg of the UAFG issue, ECCSA notes with concern that AGN has upwardly revised its forecast UAFG from the levels included in the initial proposal.

In its response to the initial proposal, ECCSA provided considerable analysis and observation about the issue of UAFG and identified aspects as to other causes of UAFG, in addition to the leakage from damaged mains. From the information provided in the initial proposal, it would seem that only ~20% of UAFG is from damaged mains with the other ~80% coming from many other causes including[14]

- "linepack factor (increasing volume of linepack from network expansions);
- pressure correction factors;
- differences between actual and billed gas pressures;
- difference between actual and standard billing temperature;
- domestic metering bias;
- errors in network injection measurements;
- differences in transmission and distribution measured heating values;
- inconsistent treatment of heating values;
- potential differences in AGN's Works Management and Metering/Billing Systems; and
- potential of missing meters in metering/billing systems."

ECCSA noted that a number of these issues are within the control of AGN and ECCSA questioned why consumers should reimburse AGN for UAFG that is within its control. ECCSA is concerned that the AER has not addressed these concerns in its draft decision when the outturn cost of UAFG to consumers is such a significant amount.

3.6 Stakeholder education and advocacy

The ECCSA is supportive of methods implemented by any national energy distribution network to actively engage their stakeholders and consumers. These views are essential as they provide the sound basis in which demonstrates whether the service provider is effectively achieving the provision of service they purport to.

[14] AGN initial proposal attachment 7.3 page 7

The ECCSA notes that the AGN has allocated $1M of opex to undertake this process and inform the initiatives outlined within the access arrangement proposal. We do not agree that 4.5 FTE staff and associated costs are warranted under this provision as service providers such as the AGN should be effectively undertaking these processes within existing opex budgets, to ensure they are providing the efficient and prudent service they are required to.

We agree with the AER's assertion that this step change is unjustifiable. Indeed, we reaffirm the AER view that the high level of guidelines provided by the AER on consumer engagement is an expectation of service providers in the manner in which to ensure a prudent and efficient service.

3.7 Step changes

AGN proposed 9 step changes to its base year opex - all of which the AER (rightly in the view of ECCSA) rejected. AGN has accepted the rejection of eight of the propose step changes but considers that one - SA44 Inlet Data Capture - should remain a step change and so increase the base year opex.

AGN asserts that the project is safety related as it does not have knowledge of the location of inlet facilities serving AGN customers. ECCSA can see that knowledge of the location of these service inlets is important but questions why after more than 15 years of regulation, AGN still does not know where it connects to its customers. The ECCSA presumes that AGN has data of all the customers that it (and its predecessor Envestra) has connected over the years (and if not why not as this is standard good industry practice!) and it would appear that AGN must only be referring to customers connected before deregulation.

If this information was not important for the past 15 years, then why is it so much more important now?

Step changes are intended to capture increased costs caused by recent changes in laws and regulation. Apparently there has been no change in laws and regulation in relation to the location of the exact location of customer interfaces with AGN assets therefore ECCSA cannot see why this issue has been raised as a step change when it is and has always been good industry practice to know where a provider interfaces with its customer.

ECCSA agrees with the AER that this is not a step change and if the information is deemed necessary, it should have been provided at the time when the connection was made if AGN and its predecessors were acting efficiently and following good industry practice. ECCSA cannot see why consumers should pay for gathering information that AGN should already have.

3.9 Summary of the ECCSA view on AGN opex

The ECCSA is of the view that the AER could be more aggressive in the reductions sought by AGN in opex for the AA2016. We reaffirm our concerns that:

- Opex in the current period (in real terms) has increased much faster than the size of the network. What we are not seeing, additionally, is a reflection in terms of the benefits of the significant capex investments over the AA2011 period

- Despite the significant capex provided to increase the network, which should have resulted in a greater efficiency of service and cost reductions for consumers, they have not seen this investment off set in the current opex.

- The use of the 2014/15 period as the base year opex, despite concerns outlined by the AER and the acknowledgement that they did not have “clear evidence” to support the resources in investigating a bottom up assessment of the AGN base year approach

- The approach to addressing UAFG leaves consumers considerably exposed to costs over which they have no control and AGN does.

ECCSA notes that the AER has applied an explicit productivity improvement factor to the allowed opex. AGN in its revised proposal has rejected this.

4. Service Performance Targets and Incentives

The ECCSA accepts the AER decision on not allowing the AGN to implement the three incentive schemes proposed by AGN – i.e. a Capital Incentive Scheme (CESS) as used in electricity networks, a Customer Service Incentive and an Innovation Incentive. Despite this, ECCSA did suggest, but the has the AER has not implemented, an incentive scheme for defined service performance standards explicitly set so that consumers can see what service performance is provided for the price set by the regulation of the monopoly service provider.

The ECCSA supports the AER argument that the there is no need for further incentives for AGN to improve its service. Indeed, the ECCSA acknowledges the AER's findings that AGN's own Stakeholder Engagement Program highlighted those AGN customers were "generally satisfied with the current reliability of the AGN gas distribution service[15]". Indeed, we note that the AGN also advises that the performance of their network is at a high standard. The ECCSA can't help but note the contradiction. On one hand, the AGN highlights a high network performance, yet is unable (or unwilling) to implement a formal incentive scheme to demonstrate its "high network performance[16]".

The ECSSA reasserts it position that, given AGN has already implied that it has already set performance targets that these should be made available to all consumers for closer scrutiny. Until a set an incentive scheme, such as that similar to a STPIS, this should be considered a benchmark for all gas distribution networks against which network service can be measured.

[15] Page 16 – AER Draft Decision – Other Incentive Schemes: Australian Gas Networks 2016-2021
[16] Page 15 – AER Draft Decision – Overview: Australian Gas Networks 2016-2021

5. Cost of Capital, Allowed Revenue and Tariffs

In its draft decision on AGN, the AER has applied its Weighted Average Cost of Capital (WACC) guideline as developed during the Better Regulation program. This results in a considerably lower value for WACC than was seen from the AGN proposal.

The ECCSA considers that AGN, by rejecting the key elements of the AER guideline, is pursuing an agenda (along with the other distribution networks) to unnecessarily maximise their revenue streams to the detriment of consumers.

The arguments about WACC provided by AGN (and other networks) all revolve around them gaining more revenue, yet this is not what the National Gas Objective (NGO) or of the Rate of Return Objective require.

- The NGO is about the long term interests of consumers. Whilst AGN argued that the AER is incorrect in its guideline, it has not demonstrated that the AER guideline is not in the long term interests of consumers and that the AGN approach is more in the interests of consumers than that developed by the AER. At a high level, the AER guideline bears much commonality to the development of the WACC seen over the past 15 years, and this approach has resulted in adequate (some would say excessive) investment in networks. It is therefore incumbent of AGN to provide evidence as to where the AER guideline would result in less investment than is needed in networks

- The Rate of Return (RoR) objective requires the AER to grant an allowance that recovers at least the efficient costs for the capital needed by the benchmark network. Again, history demonstrates that the allowances provided in past determinations have delivered this outcome. AGN needed to provide evidence that the AER guideline is so different from previous decisions that efficient costs will not be recovered. What AGN has provided is that its approach would give them higher returns, not that these returns are efficient.

The ECCSA is of the view that the AER guideline is not so different from the regulatory approaches used in the past or that the guideline is demonstrably deficient; in fact the ECCSA considers the AER guideline removes risks from AGN rather than adds them. The AGN focus is on attempting to prove that its preferred approach meets the requirements of the Rules more so than the AER approach and, by doing so, has concentrated on showing it is entitled to a higher return than that it would get from the AER guideline. What was totally absent from the AGN arguments is any evidence that the AER draft decision does not deliver an outcome which is efficient, meets the NGO and the RoR objective. The ECCSA considers that the empirical evidence from history supports the AER guideline as being more efficient[17] than the approach strongly put by AGN.

5.1 The AER draft decision

The AER has devoted considerable effort into identifying an appropriate process to develop a WACC that meets the requirements of the Rules and the intent of the National Gas Law. The bulk of the work was undertaken during the Better Regulation program which balanced the views of both the networks and of consumers whilst ensuring the requirements of the Rules were implemented. As the ECCSA commented in its response to the AGN proposal,

> "…the ECCSA supports using the [AER rate of return] guideline in its entirety rather than "cherry picking" aspects which favour one stakeholder over another."

Except for the AER draft decision on the value of "gamma", the AER has maintained the integrity of its guideline by applying it in full to its draft decision. The AER goes to considerable lengths to demonstrate that its guideline and the current assessments of point estimates remain as valid now as they did in the build-up of the guideline where all stakeholders had considerable opportunity to provide their disparate views and where the AER devoted considerable effort to balance these as it settled on a suite of outcomes the constitutes the guideline as published.

Despite the ECCSA accepting that as the rate of return guideline must be seen in its entirety and not being "cherry picked" for elements which favour one stakeholder over another, the ECCSA does highlight that there are elements of the guideline which are biased in favour of the network.

In particular, in reviewing the detailed explanations by the AER for its draft decision, the ECCSA notes that there are aspects where the AER has taken a conservative view on the parameters used to determine the final "point estimates" that are inherent in the guideline.

5.1.1 Risk free rate

ECCSA notes that the current risk free rate (the 10 year CGS) is currently about half its long term average (i.e. about 300 basis points lower than the average). This is having a major impact on the perception of the AGN proposal and the AER draft decision. If the risk free rate was at the long term average, the ECCSA considers that the revenue and the resultant notional tariff would be exhibiting increases rather than the reductions implied.

While current consumers welcome any reductions in tariffs as a result of the

[17] An efficient outcome would be where there is just enough investment to deliver the services at the required performance and no more.

lower 10 year CGS, ECCSA is concerned that as a result, there is less pressure on trying to ensure that the fundamentals of the various costs (eg growth in RAB, capex, opex, etc) are not being addressed as needed.

A return to the long term average value of the 10 year CGS will impose considerable costs on future consumers as the price of the service will be considerably higher than is implied as an outcome of the artificially low 10 year CGS.

Essentially, the current low rate masks the impacts of an excessive and unnecessarily large opex and capex program

5.1.2 Gearing and credit rating

The AER determined that the benchmark entity would be geared at 60% debt with a credit rating of BBB+. ECCSA notes that both of these elements are closely related as a higher gearing would be associated with a lower credit rating. ECCSA and its affiliate MEU have previously provided analysis of the actual levels of gearing with the actual credit ratings and this delivers an outcome that the AER gearing/credit ratings are conservative and could include a higher gearing and/or a higher credit rating for its benchmark entity.

5.1.3 Corporate bond rates

In previous submissions to the AER, the ECCSA and its affiliate MEU has observed that the corporate bond rates for entities with the same credit rating vary significantly and that energy networks appear to have lower bond rates than other firms with the same credit rating. The AER has acknowledged this previously but because the AER prefers to use third party sources of data it is constrained from adjusting the data to reflect this very apparent anomaly.

For the reasons given by the AER, the ECCSA does not propose that the bond rates used by the AER for use in setting the cost of debt should be discounted.

The ECCSA affiliate MEU has previously provided its view to the AER that using corporate bonds is a higher cost source of debt than is available from other sources - this observation has also been made by the ACCC's Regulatory Development Branch in its 2013 paper "Estimating the Cost of Debt". The AER has previously acknowledged this.

Both of these observations highlight that using estimates of the cost of corporate bonds to be the basis of the efficient cost of debt overstate the real cost of debt that networks will incur. This decision by the AER again highlights that the approach used adds another level of conservatism (which the AER acknowledges) into the setting of the WACC and provides networks with another unearned benefit.

5.1.4 Gamma

The ECCSA accepts that it is difficult to argue the individual details for each element comprising the value for gamma as there is no consistency in the data that is available.

The ECCSA considers that the draft decision on gamma (reducing it from 0.5 to 0.4) reflects a move towards more conservatism in assessing the available information.

Of concern to the ECCSA is that there is a lack of consistency in the approach for setting gamma compared to the basis for setting WACC. For example, the WACC is theoretically based on a pure play regulated energy network business operating in Australia.

However, influences on the calculation of gamma cover a much wider scope of data than this limited group of companies[18]. For example, the distribution rate is based on assessments made from data covering the entire cohort of tax payers subject to imputation. There is a basic assumption made that pure play regulated energy network businesses provide dividend imputation to their shareholders in proportion to the entire cohort of the market. This is a bold assumption. It is widely recognised that certain types of businesses provide less franking of their dividends than others - those with secure cash flows (such as energy networks) are more likely to fully frank their dividends than others. This means that imposing an assumption that the benchmark entity would frank its dividends to the market average is unlikely and therefore a conservative assumption.

Further, offshore investors in the market wide cohort have made a conscious decision to acquire assets to generate income in Australia with the full knowledge that they will not be able to benefit from imputation and this biases the data for the derivation of the utilisation rate. On this basis, it is inappropriate to reward offshore investors in energy networks by providing some return as revenue when they have made a conscious decision to invest even though they gain no benefit from imputation.

It would appear that the AER has based its assessments on lower utilisation and distribution rates than would otherwise be the case for a pure play energy network which is the benchmark entity for setting the WACC.

The ECCSA questions whether the AER is addressing the correct question with regard to imputation. The ECCSA accepts that the data reflects the utilisation of tax credits for the entire cohort of tax payers including offshore owners yet should the revenue adjustment made for regulated assets be based on data for all of the

[18] The ECCSA notes the AER approach that the utilisation factor is market wide and the distribution is firm specific

cohort or should it just be based on how a benchmark entity would operate?

The ECCSA considers that the AER has moved to a conservative position on the issue of gamma to the detriment of consumers.

5.1.5 Benchmarking

The fact that AGN has claimed a higher WACC than that resulting from the application of the AER guideline reveals a failure by the AER to carry out benchmarking of historic outturn financial performance of the energy network firms and compared these to returns seen in the wider market.

A longitudinal study of the financial performance of regulated networks compared to the wider market, after adjusting for the difference in risk profiles, would provide empirical evidence as to the validity (or not) of the claims by the distribution networks about the WACC guideline development and provide the AER with support for its view that the guideline delivers an efficient allowance for the cost of capital.

5.1.6 Conclusions on the draft decision on WACC

The ECCSA considers that the AER should apply its WACC guideline in its entirety. The ECCSA considers that there has been little new information provided that causes the need to deviate from a guideline that has only been in operation for a short time.

The ECCSA points out that the existing guideline has considerable conservatism built into it. In addition to the points made above, the ECCSA points to the setting of the equity beta (where the point estimate is set at the highest point of the credible range) and in the market risk premium (where the set point is also at the higher end of the credible range) also add considerable conservatism into the WACC calculation.

Because of the AER approach at building in conservatism at each assessment point, there is no certainty as what the overall conservatism the AER has allowed into the WACC development. The AER approach effectively results in a compounding of the levels of conservatism and as a result is likely to significantly overstate the amount of conservatism that is being provided.

The ECCSA considers that, rather than follow the AER approach at building conservatism at each point in the development of the WACC, it should set the parameters at the most likely equitable points and then add a defined amount of conservatism at the conclusion of the calculation if this is considered to be necessary.

ECCSA is very concerned that there is a view there will be a fall in the tariffs that AGN will apply. If this occurs, this fall is entirely due to the current low risk free rate which is about 300 basis points below the long term average for 10 year CGS on which the current rate of return is based. If the AER were to recalculate the revenue (and notional tariffs) based on the long term average bond rate, the ECCSA is of the view that the higher cost of capital would result in an increase in the notional tariffs but this point is overlooked by both AGN and the AER.

The ECCSA also notes that the entire issue of rate of return is still with the Australian Competition Tribunal and its decision is key to resolving the arguments that abound between the AER and the distribution networks

5.2 The AGN revised proposal

ECCSA notes that AGN disputes the AER draft decision in relation to RoR and has provided a RoR that is even higher than that in the initial proposal which the AER rejected and implemented a lower rate.

In its revised proposal, it is clear that AGN provided a revised RoR that positions it to benefit from any decision of the current review by the Competition Tribunal on rate of return based on the appeal by the NSW electricity distribution networks.

The ECCSA notes that AGN devotes considerable effort in trying to prove that it is entitled to a higher WACC than that set by the AER. What is absent from the AGN assessment is any reference to two recent sales of energy network assets - specifically the sale of Envestra (AGN itself) and the more recent sale of TransGrid. In both sale processes, the sale price significantly exceeded to RAB by a considerable margin.

ECCSA is aware that the sale price of an asset is usually based on the expected revenue derived from the asset over time. As is well recognised, the cash flow form a regulated energy network is primarily driven by the return on capital invested (ie the WACC*RAB) and this is consistently in the range of 50-70% of the allowed revenue. With the RAB identified, it is the value of the WACC that drives this major part of the future revenue stream.

Before both sales, the AER guideline for development of the WACC was released so that potential acquires of the AGN and TransGrid assets were fully aware of the intentions of the AER. The sale of Envestra preceded any decision to appeal the AER WACC guideline and the sale of TransGrid occurred before any result was seen from the appeal of the AER WACC decision by the Competition Tribunal. Despite this, the two sales occurred with a significant premium on the RAB paid by the ultimate acquirer of the assets.

This actual market outcome provides a very clear indication that not only is the AER guideline on WACC seen as delivering an acceptable return on the investments made, but that there is support for a view that the AER guideline itself is conservative and the acquirers would accept an even lower WACC than comes from the AER guideline.

ECCSA sees the arguments provided by AGN in support of increasing the WACC are a mere regurgitation of the arguments provided in the initial proposal but augmented by a desire to be able to access any positive outcome for networks from the appeal to the Competition Tribunal.

ECCSA has not been able to identify any new arguments in the AGN revised proposal that have not already been put in previous proposals by energy networks and rejected by the AER

5.2.1 Financeability

ECCSA notes that AGN makes considerable reference to the financeability that results from the cash flow allowed by the AER. Specifically, AGN pointed out that the allowed WACC must result in sufficient cash flow in order to provide AGN to access the debt funds it requires in order to stay in business.

In that element of the revised proposal, AGN points out that the allowed cashflow must be to allow recovery of efficient costs and provide an ability to continue with efficient investment. AGN also points out that insufficient cashflow will not provide the incentives required under the rules.

To address this issue, in addition to WACC, AGN makes reference to the amount of depreciation it is allowed and implies that some form of accelerated depreciation would also enhance its cash flow. AGN proposes that depreciation be enhanced by increasing the indexation of the RAB by 2% above forecast inflation in order for the cash flow to remain financeable. Despite considerable misgivings enunciated by the AER in its draft decision, AGN considers the AER has erred in setting the WACC and the depreciation schedule.

ECCSA points out that another aspect that is not addressed at all by AGN, is that the growth in the RAB (and the need for funds to support this growth) in which is a prime cause of the problem that AGN considers it has. As ECCSA points out, the growth in the RAB in nominal and relative terms has been massive in recent years and out of proportion to the amounts of gas transport capacities that consumers want and are willing to pay for. The ECCSA has highlighted that the decline in gas transport capacity sales is in part a problem caused by AGN as it consistently seeks to increase the costs for a service that in fact is being used less and less. The benefit AGN has is that the rules for regulation allow it to continue to provide inefficient services when in a competitive environment an asset owner would be taking immediate steps to reduce its costs to make its service more attractive to consumers. ECCSA members advise that this is what they are having to do on a consistent basis.

5.3 Depreciation

The ECCSA accepts the AER's position to not permit AGN to make depreciation approach contingent upon the allowed RoR, and thus be satisfied that these allowances will continue to encourage efficient investment.

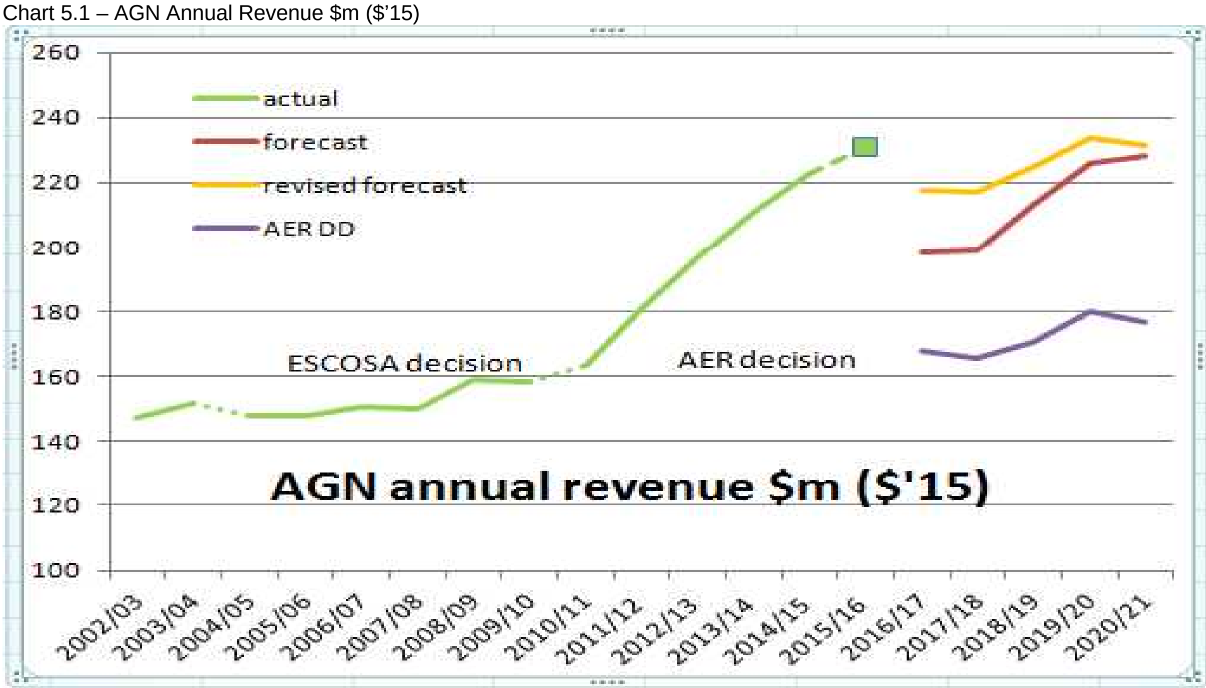
The ECCSA supports this view, however, and recognises that the discussion of the utilisation of accelerated depreciation is a new method for the networks to seek an increase in revenue and reduce risk. The ECCSA highlights that, whilst risk mitigation is a useful business tactic, it is important to consider the long term affects these have on consumers. It is the view of the ECCSA that the implementation of increased depreciation will only serve to the benefit of networks, and not that of the consumer. Using accelerated depreciation, assets can be "written down" much faster than implied by their engineering lives providing the networks with increased "free cashflow"[19] which can be taken as profit or used to justify new capex prematurely, such capex costs, as we know, are ultimately paid for by the consumer

5.4 Revenue allowed and the impact on consumers

ECCSA notes that the revenues initially sought by AGN reflected a significant reduction compared to the revenue allowed in the current period. This is shown in the following chart.

[19] Depreciation is a non cash item and therefore the depreciation allowance provides revenue against which there is no cost to the business

Chart 5.1 – AGN Annual Revenue $m ($'15)



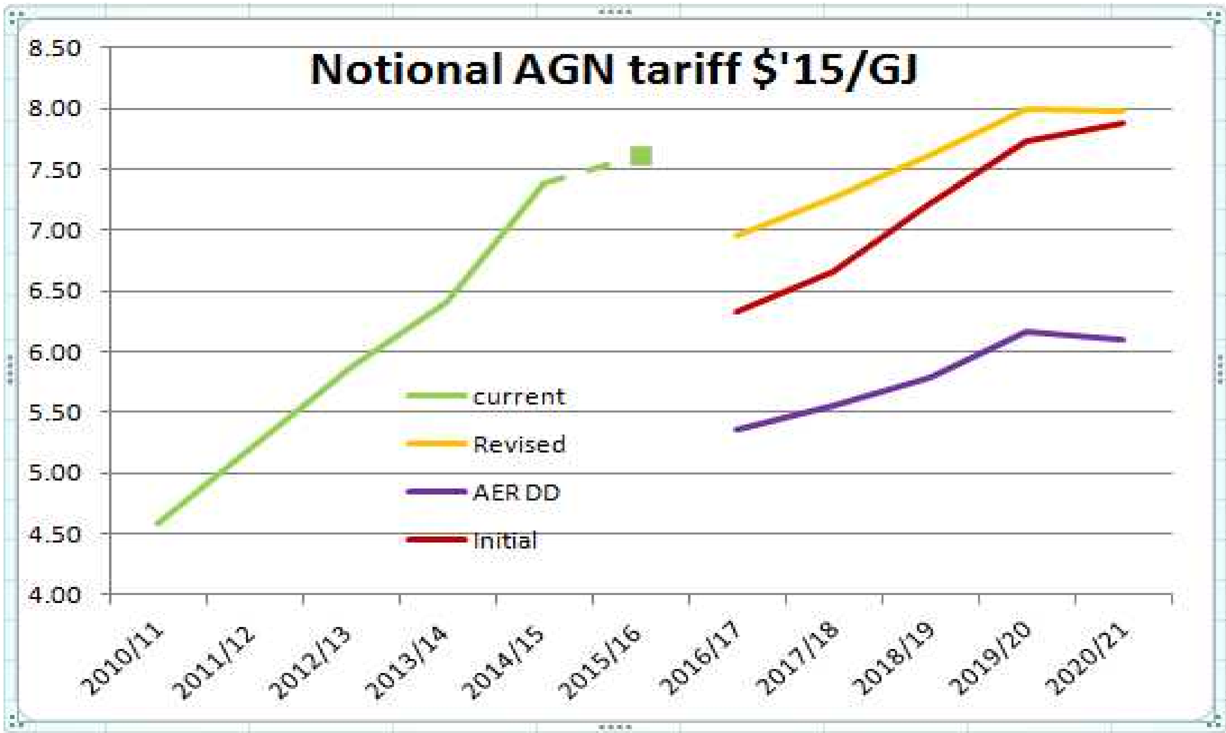
Source: AGN RIN data, AGN initial and revised proposals, AER DD, ECCSA analysis

However, the AER draft decision reduces the revenue allowance to levels similar to those applying earlier in the current period and not much more than those applying under the ESCoSA regulation. ECCSA notes that the bulk of the reduction in revenue is attributed to the lower cost of capital used by the AER.

The revised proposal results in revenues similar to those applying in the current period. The ECCSA notes that even the revised proposal has a WACC less than applying in the current period. The clear import of this is that other cost impacts have risen considerably in relative terms and supports the ECCSA view that in particular the RAB has risen to excessive levels. The ECCSA considers that the AER needs to address this issue in detail.

What is even more concerning is the rise in the notional tariffs as portrayed in the following chart which show the revenues spread over the amount of tariff D contracted capacity plus Tariff V volume forecast by AGN in its initial proposal.

Chart 5.2 – Notional AGN Tariff $'15/GJ



Source: AGN RIN data, AGN initial and revised proposals, AER DD, ECCSA analysis

There are two key aspects that this chart highlights:

1. The rapid rise in the notional tariff (about 70%) from the start of the current period to the end of this period. What is important to note is that prior to the current period, the notional tariff exhibited a more constant notional tariff over time.

2. The initial proposal shows a significant step reduction with the notional tariff rising to exceed the current very high notional tariff. The revised proposal has a larger step reduction but also finally delivers a notional tariff at the end of the period similar to that inferred from the forecast form the initial proposal. In contrast the AER draft decision delivers a notional tariff similar to that typical of the middle of the notional tariffs for the current period

What is concerning is that even the AER draft decision does not return the notional tariff to levels seen at the start of the current period and this is a reflection of the falling amount of capacity being sold by AGN.

A further important issue is that the proposed fall in tariffs for the start of AA2016 are a direct result of the current low cost of capital which is typified by the low 10 year bond rate presently in force. This low bond rate is about half of the long term average[20] therefore when the bond rate returns to its long term average, there will be a massive

[20] The long term average is the where the bond rate was when the revenue of the current period (AA2011) was set

impact on consumers as tariffs will have to increase by more than 50% to accommodate the rise in the cost of capital.

The ECCSA considers the AER should carry out analysis of what the tariffs might be if and when the risk free rate returns to its long term average as such an analysis will highlight the impacts of the growth in RAB, capex and opex that has occurred.

5.5 Pass through events

The ECCSA identified 2 significant areas of concern within proposed Pass Through Events by AGN. These being:

1) Changes in natural disaster events; and,
2) Security of Supply event

The ECCSA is pleased to note that the AER did not support the proposed change in the significant safety event, and indeed, agree with the AER view that this definition remains too broad. We welcome this position of the AER.

We are pleased to note that the ECCSA concerns relating to the scope of pass through events that the AGN can approve additional expenditure has been acknowledged by the AER. In addition, we note the agreement in this concern held by Origin Energy and the mutual desire to see an ex ante review to ensure this decision was in the long term interest of consumers.

5.6 Tariff development

We disagree with the AER decision to implement a weighted average price cap even though a revenue cap approach transfers consumption risk to consumer. Our position on this matter was outlined in our previous submission.

We further disagree with the AER's findings on our concerns outlined regarding the potential for bias under tariff development under a weighted average price cap. We reassert our position that AGN has a greater avenue to enhance its revenue stream through maintaining price caps rather than use a revenue cap.

6. Forecasts and escalation

6.1 Demand and consumption

The ECCSA is relieved to note the AER's decision not to accept the Core Energy's forecast in relation to consumption. We note the AER's concerns on the pricing methodology utilised by Core Energy, specifically the effect of "double counting" the reduction of gas consumption. This inflated reduction only serves to AGN's interest, as the lower the forecasts, the higher tariffs AGN can apply.

The ECCSA welcomes this development and decision of the AER and believes it to be in the best interest of South Australian consumers.

6.2 Cost escalators

The ECCSA notes that, in some instances, the AER has not accepted the AGN proposal of using the averages between forecasts provided by Deloitte Access Economics' and BIS Shrapnel (BIS), and in some other instances, not wages price movement indicators. Whilst we welcome some of these developments, we maintain our concerns that the use of these two forecasts historically has not been very accurate.

We accept the AER decision to make these changes when assessing the Rate of Change and assessing updated labour price forecasts from DAE. In addition, we accept the AER decision to assess all labour and non-labour at 62 per cent weighting as has been done so by in a recent decision for Jemena Gas Networks.

The ECCSA notes that the AER decision to use prior approaches used by the AER, and in this case supported by AGN, to use CPI as the best estimate for material price growth. As discussed previously, the ECCSA does not disagree with this position; however, we would urge the AER to consider that in this case, material price movements are less than CPI and if the AER should consider using this approach for the long term as a reversion to past practices where material price movements above CPI are allowed would result in harm to consumers as consumers would have not benefited from lower prices but incurred costs for higher prices.

6.3 Productivity benchmarking

The ECCSA notes the AER decision to apply a specific productivity improvement of 0.5% pa into the opex allowance. ECCSA agrees with the principle behind the decision but considers that the productivity rate is too low and considers that the work carried out by the Challenge Panel for the Victorian electricity DNSPs shows that opex productivity has been declining at the rate of 4% pa.

ECCSA is aware that there is no similar comparative benchmarking data developed yet for the gas distribution networks but is of the view that similar rates of decline would also have occurred in the gas networks. However, the ECCSA considers that the application of a 2% productivity improvement is a conservative assessment which could be applied to AGN opex.