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Dear Mr Anderson,

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SACOSS thanks the AER for the opportunity to comment on AGN's regulatory proposal for the 2016-2021 Access Arrangement (AA) period.

### **Demand forecasts**

AGN has forecast significant falls in demand across both residential and commercial customers. AGN is predicted a 2.8 per cent fall in residential volumes each year, and a 1.8 per cent in commercial volumes. AGN forecasts a 10.8 per cent fall in total residential demand and a 3.5 per cent fall in total commercial volumes over the course of the 2016-2020 AA period.<sup>1</sup>

These rates may be somewhat pessimistic in view of recent historical trends set out in Core Energy Group's analysis.<sup>2</sup> The forecast fall in AGN's distribution tariffs (11 per cent in real terms in 2016-17)<sup>3</sup> and expansion of the network by a forecast 38,000 customers<sup>4</sup> could assist in recovery in demand.

### **Consumer engagement and Willingness to pay**

AGN engaged in a significant customer engagement process as part of its preparations for the 2016-2021 AA period. SACOSS commends AGN for its frank, open, and upfront engagement with community groups including SACOSS.

AGN undertook a range of engagement activities including reference group consultation, online surveys, and deep dive interviews.<sup>5</sup> AGN engaged Deloitte as an independent expert to support the engagement process.

AGN presents a number of findings from Deloitte's insight report, summarised by AGN as:<sup>6</sup>

*The key feedback included that stakeholders:*

- *want more information about AGN, including our role in the natural gas supply chain and the application of regulation to the business;*
- *are generally satisfied with our customer service and reliability levels;*
- *are generally supportive of initiatives that maintain and/or improve service; and*
- *believe that AGN has a role to play in assisting vulnerable customers.*

A willingness-to-pay (WTP) assessment was conducted as part of the online survey and in workshops.<sup>7</sup> However, AGN notes that:<sup>8</sup>

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<sup>1</sup> AAI p 241, Table 14.5.

<sup>2</sup> AAI Attachment 14.1.

<sup>3</sup> AAI p. 11.

<sup>4</sup> AAI p. 36.

<sup>5</sup> AAI p. 50.

<sup>6</sup> AAI p. 55.

<sup>7</sup> AAI p. 54.

*Over the course of the survey period AGN received 247 completed surveys, 165 of which were from South Australian stakeholders and of whom 124 were natural gas consumers. Deloitte found that the survey response rate was not statistically significant.*

Given the small sample size and Deloitte's view that the survey response rate was 'not statistically significant' SACOSS considers that it may not be sensible to place significant weight on the survey findings on WTP.

AGN sets out the findings of the WTP survey to support seven actions as part of its capex program, with a central focus on improving safety. These include expanding the rate of mains replacement, fit fire shut off valves, replace above ground poly pipe and old plastic fittings, rectify sites, install remote meter reading devices, and improve coordination of capital works.<sup>9</sup> Given the complexity of some of the proposals, it would be difficult for AGN to be confident that the responses fully understood and accounted for:

- The precise nature of the proposed activities,
- The fact that some of these activities may be occurring as part of business-as-usual, or
- The relative underlying level of risk in the absence of such activities or the decrease in risk from undertaking the activity.

SACOSS considers given Deloitte's view that the survey was not statistically significant and the above reasons there is not a strong case to rely on the findings, and in particular to use the findings to justify the proposed significant capex programs.

SACOSS considers its view is supported by the fact that AGN's findings that customers are willing to pay for service and safety improvements seem at odds with the findings of the ESCOCA review of jurisdictional service standards released in June 2015. ESCOSA's report quite clearly found that consumers had no appetite to pay more for improved service levels.

ESCOSA found that:<sup>10</sup>

*Participants in AGN's stakeholder engagement program were generally satisfied with AGN's gas distribution services and reluctant to pay for improvements to current service levels. High levels of customer satisfaction are further supported by the consistently low number of complaints received by AGN and the low proportion of complaints that required escalation to the Energy and Water Ombudsman SA.*

*While service improvements are not required, the Commission has refined its reporting framework for AGN for the 2016-2021 regulatory period to remove regulatory duplication and clarify the roles and responsibilities of the Commission, the Technical Regulator and the Australian Energy Regulator (AER).*

*AGN will be required to report to the Commission on its responsiveness to public reports of potential gas leaks and customers experiencing poor reliability outcomes. The revised reporting framework will provide the necessary data to monitor any material changes in current service levels that may require service standards with performance targets in the future.*

*A Guaranteed Service Level Scheme will not be introduced for the 2016-2021 regulatory period as the costs of such a scheme (which are borne by customers) outweigh the likely benefits at this time.*

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<sup>8</sup> AAI p. 54.

<sup>9</sup> AAI pp. 62-63.

<sup>10</sup> As quoted in AAI Attachment 3.10, p. 77 of 108 (unnumbered)

## Operating expenditure

SACOSS considers that AGN has not adequately accounted for the step-change benefits of its proposed replacement of CI and UPS and HDPE program on its forecast opex for 2016-2021.

SACOSS contends that the benefits from the program could be expected to similar in type to the benefits of the program identified by AGN in the current AA period, namely a:<sup>11</sup>

- “50% reduction in CI and UPS mains and service leaks;
- 36% reduction in CI mains breaks;
- 60% reduction in customer reported supply complaints related to water in mains; and
- 34% reduction (or 730 terajoules) in unaccounted for gas (UAFG), of which a material proportion is natural gas losses on the Adelaide network.”

However, given the increase in the scale of the replacement program is proposed to increase substantially in the 2016-2021 AA period from the current AA period, these benefits could be expected to increase substantially, bringing savings in both opex and other forms of capex.<sup>12</sup>

In the coming regulatory period, AGN is proposing to increase replacements from 1172 kilometres to 1273 kilometres of CI, UPS, and HDPE, which is an increase of 101 kilometres or 8.6 per cent.<sup>13</sup> Absent other factors, this could be expected to increase savings in operating expenditure.

SACOSS advocates that the AER should evaluate the opex savings from the proposed investment program<sup>14</sup> and apply step improvements to AGN’s opex budget to account for the savings from the program.

## Benchmarking

Economic Insights conducted an analysis of the relative efficiency of AGN SA networks’ opex and capex efficiency. It found that AGN is reasonably efficient in opex (see figure 7.2).<sup>15</sup> However, its view on AGN’s multilateral efficiency was not so positive (figure 4.2).<sup>16</sup> This might suggest some trading off between opex and capex efficiency in AGN’s SA network.

AGN argued that its 2014-15 forecast opex of \$65.9m (\$2014-15) should be considered efficient.<sup>17</sup> SACOSS notes that AGN has not proposed any significant steps down from the base year opex and is instead proposing a number of steps up from the base year to arrive at proposed opex for 2016-2021 of \$352.7. This represents a step up from an unadjusted projection forward of the base year amount of \$65.9m which over five years would be \$329.5m. AGN has adjusted the base year to a total over five years of \$231.9m (around \$46m per year) but added steps up to arrive at the \$352.7m proposed opex.<sup>18</sup>

Given the potential for steps down from the base year, SACOSS would expect that, even assuming the 2014-15 opex of \$65.9m was efficient, the total opex budget would be no more than \$329.5m. Identified steps down would then take this figure lower.

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<sup>11</sup> AAI pp. 37-38.

<sup>12</sup> In fact, the business case for the investment would in practice rely heavily on these benefits being realised, particularly if the AGN’s private demand forecasts are as negative as those set out in the regulatory proposal.

<sup>13</sup> AAI p. 134.

<sup>14</sup> based on the program actually approved by the regulator

<sup>15</sup> AAI p. 113.

<sup>16</sup> AAI p. 73.

<sup>17</sup> AAI p. 113.

<sup>18</sup> AAI p. 123, Table 7.8.

### **Unaccounted for gas**

AGN forecasts \$51.9m in UAFG in the 2011-16 AA period<sup>19</sup> and forecasts \$55.4m in the 2016-2021 AA period.<sup>20</sup>

AGN's forecasts for the 2016-2021 AA period seem surprising given AGN is expecting a fall in UAFG of 20 per cent based on its CI, UPS, and HDPE replacement program.<sup>21</sup> AGN justifies its 2016-2021 forecast based on a rise in the cost of gas of around 50 per cent.<sup>22</sup>

### **Forecast UAFG volumes in 2016-2021**

AGN's forecast UAFG is based on the multiple of forecast UAFG volumes and forecast market prices for gas. SACOSS considers both of these forecasts deserve close scrutiny by the AER, particularly as AGN's forecasts of UAFG are very much at odds with the evidence from the current AA period.

SACOSS notes that AGN has withheld the report in Attachment 7.3 on which it bases its forecasts of UAFG volumes.

AGN is forecasting a 20 per cent fall in UAG in 2016-2021 with a mains replacement program of 1273 kilometres of pipes compared to an observed and forecast fall in UAFG of 34 per cent in 2011-2016 with a mains replacement program of 1172 kilometres of pipes. This equates to a rough halving of the rate of UAFG decline between the two periods (from 64 kilometres of replacements per 1% saving in UAFG in the current AA period to 35 kilometres of replacements per 1% saving in UAFG in the forthcoming AA period).

AGN argues the rate of saving in UAFG will fall given the leakiest mains have been replaced first.<sup>23</sup>

However, the observation from graph 2 at page 6 at Attachment 7.3 shows a consistent rate of fall in UAFG twinned to the rate of mains replacement. The relationship between the two is strongly constant over time. Thus it is reasonable in the absence of better evidence to forecast a more constant relationship between the rate of replacement in mains and the rate of fall in UAFG. The evidence is not supportive of a halving of the rate of decline in UAFG from the current AA period to the next AA period.

AGN points to other factors that affect UAFG volumes, such as the operating pressure of the network (where a lower operating pressure is associated with lower leakages). However, it is understood these factors are not proposed to change, and in any event the reduction in UAFG from the decrease in operating pressures in December 2011 only led to a small fall in UAFG of about 70 TJ, which was swamped by savings due to replacement of pipes.<sup>24</sup> From the publicly available material, AGN has not presented any information on other factors that are likely to change forecast UAFG volumes. AGN states that its 2016-2021 forecasts were developed holding factors other than mains replacement constant.<sup>25</sup>

### **Cost of UAFG gas in 2016-2021**

AGN forecasts a 50 per cent increase in the cost of gas in 2016-21 compared to 2011-15. SACOSS notes a number of forecasts of higher gas prices as LNG trains come into operation on the east coast of Australia, driving wholesale prices towards international pricing parity (less costs of liquefaction, transport and regasification). However, the international price of gas has fallen in

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<sup>19</sup> AAI p. 75.

<sup>20</sup> AAI p. 123.

<sup>21</sup> AAI p. 38.

<sup>22</sup> AAI p. 116.

<sup>23</sup> AAI Attachment 7.3 p.6.

<sup>24</sup> AAI Attachment 7.3, p. 5.

<sup>25</sup> AAI Attachment 7.3, p. 12, section 5.2, paragraph (b) above figure 5.2.

recent times, given its linkage to oil prices and the emergence of a major US shale oil (and gas) industry. At the same time, a number of factors are pushing domestic demand for gas lower including:

- The removal of the carbon tax, and falling demand for electricity, which are pushing gas-fired generation out of the market;
- Falling industrial production using gas due to a downturn in heavy manufacturing; and
- Increasing renewable generation lured by the RET scheme, which is again pushing gas-fired generation out of the market.

These factors would suggest that the wholesale price of gas may rise significantly less than 50 per cent in the forthcoming AA period.

### **Capital expenditure**

AGN has proposed a major rise in capex in 2016-2021 (\$699.1m) compared to the 2011-2016 AA period (\$478.6m actual capex against an allowance of \$546.9m).

The major item of forward capex is mains replacement (CI, UPS, and older HDPE), which represents 60 per cent of the total proposed capex budget.<sup>26</sup>

AGN is proposing to complete its program of replacement of CI and UPS – 862 kilometres and ramp up its program of replacement of older HDPE to 411 kilometres.

AGN's program raises two key questions:

- Is it justified on cost-benefit grounds to complete the program at this speed and scale; and
- Are the proposed costs efficient?

SACOSS also notes with disappointment that the major mains replacement program being proposed was not substantially discussed during the consumer engagement program.

### **Speed of the replacement program**

SACOSS accepts that AGN would have the capability to complete the replacement program over the 2016-2021 period. However, the question for the AERR's assessment is whether it makes good economic sense to complete the program within this short timeframe.

AGN is proposing to replace 1,273 kilometres of network out of a total network of 7,950 kilometres, or 16.0 per cent of the total network. If AGN were replacing the network at an equal rate each year, and assuming the assets have a uniform standard life of 60 years, the rate of replacement would be only 663 kilometres or only 52 per cent of the proposed rate of replacement.<sup>27</sup> In fact, many assets typically last beyond their standard life.

Factors to be considered in assessing whether the proposed rate of mains replacement is justified include:

- SACOSS notes that if AGN's mains replacement was approved, then AGN's forecast capex in the 2021-2026 AA period would fall substantially, with capex falling from \$699m to \$457m and by substantially more when sustaining or BAU capex is removed from the capex budget.<sup>28</sup> Thus this raises the question of whether a more smoothed capex program would make more sense. A compressed replacement program is likely to be more complex, and costly to manage, involve more resources hired on a temporary basis, and be more costly overall than a more smoothed replacement program.
- Do all the CI, UPS, and HDPE assets within the mains replacement program require replacement based on their age or condition or based on AGN's regulatory compliance obligations? As the mains replacement program is already well underway with around

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<sup>26</sup> AAI p. 152.

<sup>27</sup> Based on 5/60ths of the network being replaced in the upcoming 5 year AA period or 5/60ths of 7950.

<sup>28</sup> AAI p. 94.

1,172 kilometres already replaced, it may be that the remaining assets are lower priority with less justification for early replacement. Given distribution assets have a standard life of 60 years, as AGN notes, the remaining CI and UPS assets may have significant life. The HDPE assets were laid in the 1970s, meaning they are less than 45 years old and could have significant remaining life.<sup>29</sup>

- AGN points to the savings in UAFG. SACOSS suggests that if the low level of UAFG reduction forecast by AGN makes the case for a more rapid mains replacement weak. ON AGN's own figures, it forecasts a 20 per cent reduction in UAFG for a saving of a modest \$13.85m in UAFG opex costs over the 2016-2021 AA period, or less than \$3m in opex per year.<sup>30</sup> Against that, SACOSS considers AGN has probably understated the likely UAFG reductions (as discussed above) but even if the UAFG saving was doubled it would be \$6m per year. If the rate of the mains replacement program was halved from \$400m to \$200m over 2016-2021, then the \$200m capex deferral would be considerably greater than the UAFG savings, either at AGN's proposed WACC of 7.23 per cent or at a lower rate such as 5.45 per cent.<sup>31</sup>
- AGN points to benefits in terms of increased capacity to support instantaneous hot water systems.<sup>32</sup> However, given AGN is forecasting significant falls in total demand for both the residential and commercial sector, the current system may well be able to cope with rises in peak demand among the remaining load. It is noted that when AGN asked the Core Energy Group to forecast demand it did not ask Core to forecast peak demand in the form of MDQ for either the residential or commercial tariff classes.<sup>33</sup> This suggests AGN was not focussed on the contribution from these tariff classes to peak demand.
- AGN also points to benefits of the mains replacement program in terms of better public and employee safety.<sup>34</sup> However, there are few identified public safety issues with the network. In terms of employee safety, AGN notes that it "achieved industry best practice employee safety levels over the current AA period. .... In 2013/14, there were 1.3 lost time injuries per million hours worked".

SACOSS would urge the AER to consider carefully whether the program should be completed at the rate proposed by AGN.

### **Proposed cost of the replacement program**

A second consideration is the high proposed cost of the replacement program.

In 2011-2016, AGN was able to replace 1,172 kilometres of pipe (1,072km of CI and UPS and 100km of HDPE) at a cost of \$247.7m. However, for the 2016-2021 AA period, AGN is proposing to replace 1,273 kilometres of pipe (862km of CI and UPS and 411km of HDPE) at a cost of 416.7m.<sup>35</sup> Assuming that HDPE costs the same as CI or UPS to replace, this suggests a rise in the cost of replacement per kilometre of pipe from \$211,000 per km to \$327,000 per kilometre from the current AA period to the future AA period. This represents an increase in the costs per km of replacement of 55 per cent (in comparable 2014-15 dollar terms).

AGN has not adequately explained why the costs of replacement would dramatically rise by 55 per cent from the current AA period to the future AA period.

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<sup>29</sup> AAI p. 93 and p. 94.

<sup>30</sup> This is calculated on the assumption that the forecast cost of 55.4m represents 80 per cent of the costs so the saved 20 per cent is \$13.85m

<sup>31</sup> Halving the rate of mains replacement would result in halving of the UAFG at most, costing UAFG of \$1.5 to 3m per year more than the proposed mains replacement program. The annual saving on say \$200m of capex deferral would be around \$11m, even at a WACC of 5.45 percent.

<sup>32</sup> AAI p. 93.

<sup>33</sup> AAI p. 221.

<sup>34</sup> AAI p. 93.

<sup>35</sup> AAI p. 77, Table 4.4 and AAI p. 151, Table 8.16. All figures are \$2014/15.

In fact, there are factors suggesting that the costs of replacement per km would be likely to fall in the future AA period. These are that:

- AGN has increased its experience in these operations over the current AA period;
- HDPE may be significantly cheaper to replace than CI or UPS because poly pipe is easier to handle and replace than steel. IN the coming AA period, far more of the replacement is of HDPE (rising from 9 per cent to 32 per cent of the total replaced mains);<sup>36</sup> and
- Newer replacements may be further from the city, meaning lower costs associated with site access and replacement and resurfacing following trenching operations.

SACOSS would urge the AER very carefully to consider AGN's proposed capex costs for mains replacement and to justify exhaustively the reasons for the major increase in the cost per kilometre of replacement.

### **IT capex projects**

AGN has proposed a substantial IT capex budget of \$66.7m or 10 per cent of the total capex budget.

These projects deserve scrutiny to ensure:

- They are projects that AGN needs to spend on given it does not have a network operational or management role. As AGN has outsourced this role to APA, it is unclear why it would need to spend as much on some of the IT programs such as geospatial IS or mobility IT. Alternatively, AGN may be able to more cheaply licence relevant IT software systems developed by APA.
- If these projects deliver benefits in terms of improved productivity, such as the applications renewal program of \$17.7m, AGN should be able to identify the opex savings from the rollout of these programs, and include the savings in the opex budget.
- As AGN has five networks around Australia with 1.2million customers, 23,000 kilometres of natural gas distribution networks and 1,100 kilometres of transmission pipelines<sup>37</sup>, it will be important to ensure that the costs of IT programs that benefit multiple networks within the business are properly spread across the five networks rather than loaded on to one or two of those networks. The AGN SA network is about 7,950 kilometres of the total 23,000 kilometres of distribution network or only 34.6 per cent of the total distribution network (even less of the combined transmission/distribution network).

### **Incentive schemes**

#### **Capital Efficiency Sharing Scheme**

SACOSS would argue against adoption of a CESS because it is difficult to be confident about the efficient or required level of capex for the 2016-2021 AA period. Applying a CESS might simply result in a windfall revenue gain to AGN if the AER allows an amount in excess of the reasonable capex forecast. SACOSS notes the wide range of variances in the 2011-2016 AA period between the AER allowance and the actual expenditures, between minus 4 per cent and minus 24 per cent.<sup>38</sup> These variances indicate the difficulty of assessing efficient capital expenditure.

SACOSS notes that AGN was able to deliver savings in the current AA period compared to the AER allowance. AGN spent 339.0m in capex compared to an allowance of 370.3m. This was despite a slow start to the capex program (due to uncertainty at the start of the 2011-2016 AA period noted by AGN<sup>39</sup> and spending on 100 kilometres of HDPE being brought forward that was not allowed in the capex budget.<sup>40</sup>

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<sup>36</sup> 100/1172 rising to 411/1273.

<sup>37</sup> AAI p. 29.

<sup>38</sup> AAI p. 76. Excluding the variation on debt raising costs, which was only a small variance in total terms.

<sup>39</sup> AAI p. 76.

<sup>40</sup> AAI p. 37: "The HDPE mains replacement program was not included in the capex benchmarks set by the AER for the current AA period".

SACOSS considers that a number of factors are likely to provide sufficient incentives to reduce capital costs over the 2016-2021 AA period where possible and efficient to below the capex allowance. These include:

- The ability to earn a return on forecast capex and depreciation as the forecast capex is assumed to be added to the RAB;
- Having the use of the allowed capex for the 2016-2021 AA period;
- Managing the risk of the RAB and resulting revenue requirement growing to the point where it risks asset stranding. This possibility is greater given AGN forecast gas use to fall significantly in 2016-2021, gas use is somewhat discretionary compared to electricity use<sup>41</sup>, and technological change is emerging in related electricity markets which could be expected to increase risk in gas use markets.<sup>42</sup>

### **Efficiency Benefit Sharing Scheme**

SACOSS would similarly argue against an EBSS given uncertainty in forecasting required opex could lead to a windfall gain for AGN and the fact that AGN already has incentives to reduce opex below allowed levels.

SACOSS notes that AGN has argued for an increase in the EBSS sharing ratio to 50:50, i.e. that AGN should retain 50 per cent of the opex savings realised in the 2016-2021 AA period.<sup>43</sup>

SACOSS would argue against this. AGN has been able to deliver savings in opex compared to the AER allowances in the current AA period. Moreover, AGN's mains replacement program and proposed IT programs could be expected to deliver significant savings in opex going forward. Thus a significant proportion of savings compared to current opex levels may come from AGN's capex program rather than efficiency improvements. The EBSS should be directed at rewarding efficiency improvements rather than in changes in the ratio of capital to operating expenditure, or increases in the capital intensity of operations, where that capex is allowed by the AER.

AGN argues that the sharing ratio should be changed as it has been subject to incentive regulation for a considerable period of time and efficiency savings are becoming more difficult to achieve.<sup>44</sup> However, when AGN's SA network is benchmarked against other networks it does not emerge as a particularly efficient network, for example placing second last on the Australian GDB Multilateral TFP Indexes 1994-2014 against a cohort of six, and with a decline in its ranking relative to other gas distributors over that period.<sup>45</sup> This would suggest the SA networks have significant scope for improvements in efficiency.<sup>46</sup> Additionally, improvements in technology (such as geospatial systems, mobility systems, and horizontal drilling among other areas) are likely areas of productivity improvement. SACOSS notes that AGN is proposing a substantial IT capex budget aimed at some of these areas.

AGN argued for strong incentive arrangements.<sup>47</sup> It considers that incentive arrangements can boost the slowing rate of gain in productivity observed in more recent times, and spur more costly and difficult to achieve efficiencies.<sup>48</sup>

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<sup>41</sup> AGN describes gas as a 'fuel of choice': AAI p. 39.

<sup>42</sup> AAI pp. 220-221 identifies some of the same factors.

<sup>43</sup> AAI p. 91.

<sup>44</sup> AAI p. 92.

<sup>45</sup> AAI p. 73.

<sup>46</sup> AGN argues it is efficient given its small size and low customer density: AAI pp. 73-74. However, APA undertakes most of the operations under a contract with AGN across AGN networks, giving APA considerable national economies of scale in network operations.

<sup>47</sup> AAI p. 189.

<sup>48</sup> AAI pp. 196-197.



SACOSS considers that observed slowing in productivity improvements and total factor productivity can be attributed to a range of factors including expanding RABs, rising wages in the utilities sector due to competition from other sectors of the economy, and falling demand. SACOSS would argue that weak incentives are not likely to be a substantial reason behind the observed productivity trends.

### **Network Innovation Allowance**

AGN is proposing a Network Incentive Allowance (NIA) to reward innovations that might result in benefits in the longer term, and which could otherwise be lost under the arrangements where operating or capital efficiencies are clawed back at the end of each five year AA period.<sup>49</sup> SACOSS agrees there is benefit in innovating to improve productivity. SACOSS would support a NIA on the conditions proposed by AGN so long as the NIA expenditures and revenues are capped. Given the NIA is a new scheme it may be appropriate to cap NIA revenues at a reasonably low level, say around \$2m per year.

### **Customer Service Incentive Scheme**

AGN is proposed to introduce a new Customer Service Incentive Scheme (CSIS) from July 2017 after further engagement with customers.<sup>50</sup>

A key consideration in the introduction of such a scheme is whether existing standards are sufficient to meet customers' aggregated needs. ESCOSA's final report on jurisdictional service standards was quite clear that there are no grounds for providing incentives to improve service. On this basis, SACOSS does not support a CSIS for introduction in 2017.

### **Weighted Average Cost of Capital**

The cost of capital is a critical input for utilities given their highly capital-intensive nature. Gas pipelines and networks are by their nature much more capital-intensive even than electricity networks. This makes it important to set the rate of return at an appropriate rate and not set it so high that it lures in inefficient investment.

SACOSS notes that AGN is proposing major new investment in the network at the same time as it is predicting a substantial fall in demand from both residential and commercial users (17 per cent and 6 per cent respectively) and a high prevailing cost of gas (which AGN forecasts to rise by 50 per cent in the coming AA period).<sup>51</sup>

AGN has proposed a WACC of 7.23 per cent based on a rate of return on equity of 9.91 per cent and a rate of return on debt of 5.44 per cent at a leverage of 60 per cent.<sup>52</sup>

AGN has proposed a number of variations from the AER rate of return guidelines, including:<sup>53</sup>

- Using a multi-model approach to determine the rate of return on equity rather than solely using the Sharpe-Lintner CAPM model;
- Using an equity beta of 0.82 and a market risk premium of 8.23%; and
- A hybrid transition approach to the 10 year trailing cost of debt.

SACOSS has addressed similar proposed variations in respect of the first two variations in its submission on SAPN's regulatory proposal. SACOSS considers its arguments and those of SACES are relevant to assessing AGN's WACC proposal.

SACOSS considers there are strong grounds to adopt the approach proposed by SACES in determining the equity beta, market risk premium, and approach to calculating the cost of equity.

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<sup>49</sup> AAI pp. 200-205.

<sup>50</sup> AAI pp. 200-201 and 206.

<sup>51</sup> AAI p. 116.

<sup>52</sup> AAI p. 176.

<sup>53</sup> AAI p. 175.

AGN's third variation is to propose that the ten-year trailing average approach to the cost of debt be calculated on the basis of a transitional approach under which there is "a 10-year transition to the base rate component but not to the debt risk premium (DRP) component of the cost of debt".<sup>54</sup>

The cost of debt is calculated as a risk-adjusted premium (or debt risk premium) to the risk-free rate. AGN's approach effectively proposes to freeze the debt risk premium to the risk-free rate at the rate that applied from 2005-2014 plus the placeholder period of 9 February 2015 to 6 March 2015.<sup>55</sup>

In support of its proposed hybrid transition approach to the cost of debt, AGN argues that:<sup>56</sup>

- "no transition is required for the debt risk premium component of the cost of debt given businesses such as AGN already have a trailing average DRP (reflecting that it is not possible to 'hedge' the DRP)"; and
- "The hybrid transition approach is consistent with the actual transactions that a benchmark efficient entity facing the risks of AGN would need to enter into to transition to the 10-year trailing average approach".

AGN's arguments rely on the view that debt is calculated on an historical or backward-looking basis. AGN proposes to look back ten years to the period starting July 2005 to calculate the 10 year trailing average. This period includes a period of very high debt costs consequent on the global financial crisis, during which investors became risk-averse and priced risk very highly to the risk-free rate. SACOSS considers AGN's approach is contrary to the approach in financial markets including to the logic of AER's 10 year trailing approach.

The AER's 10 year trailing approach is built on the assumption that firms roll over one-tenth of their debt each year. This approach reduces the firms' exposure to variability in the cost of debt and to mirror general practice by unregulated and regulated firms alike.

Under the AER's approach, firms take the prevailing cost of debt at the time of roll-over for the debt to be rolled over, and not an average of the cost of debt over the previous ten years. Moreover, the debt risk premium is forward-looking based on the risk-tolerance of investors to perceived market conditions at the time that debt is assumed to be raised. As the global financial crisis recedes, the debt risk premium to the risk-free rate can be observed to have changed, meaning that the argument to hold it constant and to set it on a backward looking basis are both inconsistent with financial market theory and practice.

SACOSS proposes that the AER use its approach under the AER guideline for determining the transition to the 10 year trailing average for the cost of debt.

### **Other issues**

AGN states it is proposing to remove a number of zero consuming meters from the network. SACOSS considers that if zero consuming meters are removed from the network it would make sense that they should be removed also from the RAB.

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<sup>54</sup> AAI pp. 174-175.

<sup>55</sup> AAI p. 175.

<sup>56</sup> AAI p. 175.

We thank you in advance for your consideration of our comments. If you have any questions relating to the above, please contact SACOSS Senior Policy Officer, Jo De Silva on 8305 4211 or via [jo@sacoss.org.au](mailto:jo@sacoss.org.au).

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Ross Womersley', with a large, sweeping flourish at the end.

Ross Womersley  
Executive Director

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