ECA RESPONSE TO AGNSA'S 2021-26 ACCESS ARRANGEMENT PROPOSAL

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EXECUTIVE SUMMARY

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OVERARCHING OBJECTIVES THAT SHOULD FRAME AGNSA'S 2021 PLAN

- We have approached our review of AGN SA's 2021 Plan by focusing on the following objectives, as they are are all relevant to the long-term interests of consumers with respect to price, reliability, quality and security of supply:
  - Network tariffs must be ***affordable***, a function of ***individualised*** services and provided within an ***optimised*** system.
  - Gas prices must be kept as low as possible for today's household and small business consumers.
  - Current and future consumers should be paying no more than they need to for the quality of service they require - "Not one dollar more is spent than necessary; Not one day earlier than needed".
  - There should be sufficient information made available to demonstrate that the proposal promotes the long-term interests of customers.
  - There has been meaningful consumer engagement in developing key aspects of the proposal.
- Achieving these objectives will:
  - help keep network prices as competitive as possible;
  - maximise the incentive for consumers to continue usage of the network for the foreseeable future; and
  - align very closely with the interests of network investors to give them the best chance that they will be able to recover their investment and earn a return on that investment.
- This is in the long term interest of today's and tomorrow's consumers and investors in infrastructure.

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KEY FEATURES OF AGNSA'S PLAN THAT ALIGN WITH ECA OBJECTIVES

There is substantial alignment between AGN SA's Plan and the interests of household and small business energy consumers.

2021 Plan Feature	Relevant ECA Objective
• An upfront price cut of 6.5% from 1 July 2021 (for the first year), although for following years, there are annual price increases of 2.8%pa for the remainder of the 5 year plan	Long term consumer interest with respect to price
• Sharing of initial year's tariff reductions across all customer classes	Long term consumer interest with respect to price
• AGNSA is not proposing any changes to its current approach to depreciation in response to the energy transition, instead preferring to wait for more information to become available on the role of gas in a low carbon future	Long term consumer interest with respect to price
• Adoption of the AER's Rate of Return guidelines position, corporate tax position and inflation position	Long term consumer interest with respect to price

However, in our view there are outstanding features of the Plan where there are areas for improvement or aspects which we believe requires further investigation by the AER, before the Plan could be considered capable of acceptance by the AER.

The following slides comment on each of the aspects of AGNSA's 2021 Plan:

- - consistent with key objectives
- - further work or analysis required before ECA should accept that it is consistent with key objectives and capable of acceptance by AER

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RESPONSE TO AGNSA'S 2021 PLAN FEATURES

Focus Area	AGNSA's Proposal	Our Position
Actual Capital expenditure	• AER should satisfy itself of the adequacy of the capex cost allocation methodology as a result of AGIG merger, particularly for IT & overheads capex	☜ (slides 11 &12)
	• Connections capex unit rates need to be scrutinized more closely by AER	☜ (slides 9 & 10)
	• The rate of replacement of meters with new meters instead of refurbished ones should be benchmarked against replacement rates for other networks with similar meters	☜ (slides 10 & 11)
Inflation	• Support the adoption of the AER's position on inflation but we encourage the AER's current consultation process on inflation to be completed in time for the issuing of the Draft Decision	👍
Depreciation	• No change to current approach to depreciation in response to the energy transition, instead AGNSA will wait for more information to become available on the role of gas in a low carbon future	👍
Rate of return	• Accept AER's approach in guidelines	👍
Tax (and gamma)	• Calculated in line with the AER's final tax decision and rate of return instrument	👍

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RESPONSE TO AGNSA'S 2021 PLAN FEATURES

Focus Area	AGNSA's Proposal	Our Position
Forecast Capital expenditure	• A cost/benefit analysis and risk assessment should be submitted to inform whether it would be more prudent to carry on with the mains replacement program as proposed or deferring some or all of this project until more information is known in 2022 about hydrogen.	☜ (slide 12)
	• Capex cost allocation methodology needs to be retested by the AER in light of the AGIG merger in 2017, particularly with respect to the overheads capex and capex associated with IT projects such as the IT strategy and roadmap	☜ (slides 11 & 12)
	• Further analysis required as to why integrity dig ups are required if in line integrity systems are being implemented	☜ (slide 12)
	• Further analysis required as to why an almost 300% increase in the "Other capex" category of expenditure is being proposed.	☜ (slides 12)
Operating expenditure	• Total forecast opex ($357m) is around 8% ($27 million) higher than what AGN expects to incur in the current AA period	☜ (slides 13-15)
	• Offset a portion of unaccounted for gas (UAFG) with biomethane, which is a net carbon neutral gas.	☜ (slide 14)

RESPONSE TO AGNSA'S 2021 PLAN FEATURES

Focus Area	AGNSA's Proposal	Our Position
Operating Expenditure	• Propose to use 2019-20 opex levels as the base year in the base-step-trend methodology	
	• 4 key initiatives to assist vulnerable customers reduce the financial barriers that some may face in terms of utilising gas more efficiently and/or ensuring their appliances are operating in a safe and reliable manner	(slides 16–17)
Demand	• Continuation of the demand forecasting methodologies accepted by the AER for AGNSA's 2016 Plan and in the most recent Vic AGN plan	
COVID Impacts	• Forecasts haven't been adjusted to address impacts of COVID. This will be done in response to the Draft Decision	(slide 26)
Pricing and service levels	• upfront price cut of 6.5% (after inflation) for the first year of the 2021 Plan but a 1.25% pa (nominal) increase for the remaining years of the Plan	
Incentive Mechanisms	• Propose to continue with a CESS and EBSS but also introduce a Network Innovation Scheme	(slide 24)

COMMENTS ON SPECIFIC BUILDING BLOCKS

ROLL FORWARD OF RAB – ACTUAL CAPEX

- While total actual/estimated capex between 2016-21 is well below the AER approved total (by 8%), there are significant divergences in most line items.

Capex Category	Actual 16-21 Expenditure ($m)	Variance from AER approved forecast (%)
Connections	143.735	⇧50%
Mains Augmentation	11.072	⇩34%
Mains Replacement	262.114	⇩15%
Telemetry	0.961	⇩21%
Meter Replacement	22.231	⇧19%
ICT	40.997	⇩33%
Capitalised overheads	46.559	⇩21%
Other	27.987	⇩32%

- We expect the AER's capex expert will revisit the business cases and request more detailed information in support of AGNSA's actual expenditure levels and, in some cases, unit rates. We have raised some issues with some specific capex issues in the next slides.
- These divergences also raise an issue the AER should consider in more detail - how reliable are past capex levels as a guide for assessing the prudency and efficiency of AGNSA's forecast capex in the 2021 Plan? This is particularly important if a CESS is to apply.

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ACTUAL CAPEX ISSUES

Actual Capex Issue		Our Comments
Connections	☞	We would expect more information to be made available to substantiate the key reasons for higher unit rates as outlined in the Capex Supporting information document, in particular: - Why are actual contractor rates for new mains capex in areas close to CBD higher, particularly given the amount of work that AGNSA has undertaken on new mains and mains replacement over the last few years? We would have expected that this would not only have given AGNSA detailed information to ensure that its forecast approved by the AER in 2016 was fairly accurate but it would also have delivered AGNSA significant leverage in negotiating rates with contractors for connections. Also, we would expect the AER to explore how AGNSA's actual unit contractor rates for new mains capex are higher but yet its rates for mains replacement for forecast capex is lower (compared with the unit rates approved by AER in 2016).
Mains augmentation	☞	We would have expected AGNSA to be providing the AER with the details of a risk assessment that demonstrated there were no safety or integrity risks as a result of deciding not to undertake this augmentation work.

ACTUAL CAPEX ISSUES

Actual Capex Issue		Our Comments
Meter replacement	☜	The AER should look to compare the rates with the replacement rates of other networks that have similar meters to AGNSA.
IT System capex - incurred to nationalise and consolidate major IT applications, leveraging the capability of these systems through AGNSA's application renewal program and building digital capability	☜	While it is noted that actual ICT expenditure levels for 2016-20 are 33% less than the forecast approved by the AER for that period, we would expect the AER to inquire as to what was involved in nationalising the IT applications and the extent to which the costs have been allocated between the various AGIG businesses given that: - Its not clear which of the projects incurred (as summarised on p20 of Attach 8.6) relate to nationalising and consolidating; - It is not apparent that this was an assumption when the AER assessed the forecast for the 2016-20 plan; and - The cost allocation methodology that the AER would have relied upon in assessing the forecasts for 2016-20 would not have assumed an allocation across all of the businesses that now make up AGIG (given that AGIG was not established until 2017).

FORECAST CAPEX ISSUES

Forecast Capex Issue		Our Comments
$389m for safety and reliability projects (including mains replacement program for 860km)	☜	Given AGN is of the view that, by 2022, it will have more information available to determine the viability of renewable gas in the network, the AER should consider undertaking a cost/benefit analysis and risk assessment to inform whether it would be more prudent to carry on with the mains replacement program as proposed or perhaps deferring some or all of this project until that information is to hand.
Forecast growth expenditure	☜	There appears to be an inconsistency in the Plan as to the total of forecast growth related expenditure. Section 8.6.6 of the Plan refers to a forecast of $149m whereas sections 8.5.2 and figure 8.3 refer to a forecast of $159m.
Forecast IT expenditure - $13.5m for the AGIG IT Strategy & Roadmap (SA138)	☜	Similar comments apply for the forecast ICT capex as were mentioned in the section of this report relating to actual capex for IT expenditure. In addition, we would expect the AER to inquire as to the basis for the cost allocation methodology adopted to derive the percentages of the total capex for this project to be allocated to firstly the AGN overall business and then to AGNSA (see Figure 1.1 and Appendix C of Attachment 8.8 for project SA138).
Other forecast capex of $62m	☜	We would expect the AER to make further inquiries as to why integrity dig ups are required to the same extent as in the 2016 Plan if in line integrity systems are being implemented during the 2021 Plan.

OPERATING EXPENDITURE (OPEX) ISSUES

- AGNSA's opex levels generally appear to be around average compared with other Australian & NZ gas network operators, based on a number of benchmarking indicators presented in the Economic Insights report:
  - While AGNSA has higher opex per customer, when compared to the five largest networks, this can be fully explained by its smaller scale, lower customer density and differences in the other identified cost drivers
  - AGNSA's normalised real opex per customer is below the sample average and at a similar level to the normalised average of the five largest Australian GDBs.
- However, AGNSA is proposing a total forecast opex of $357m which is ~8% ($27 million) higher than what AGN expects to incur in the current AA period.
- While the proposed methodology for setting the forecast opex for the Plan is largely consistent with the AER's methodology adopted in current plan, we have some comments on the following slides.

OPERATING EXPENDITURE ISSUES

Step		Our Comments
Establish an efficient base year	👍	• We support the use of 2019/20 opex as the base year given that it's the year with the lowest level of opex in the current 5 year plan.
No movement of capitalised overheads to opex during the 2021 Plan	👍	• We support the change in approach on this issue from the Draft Plan to the 2021 Plan given that forecast opex levels are already proposed to be 8% higher than current levels. This focuses on the need to keep prices as low as practicable for consumers.
Unaccounted for Gas (UAFG)	☜	We would expect the AER to require further information on: - Why the expert report concludes that the Market Price for UAFG, for an organisation like AGNSA (which has size (as part of AGIG) and both distribution and transmission pipeline experience), should be assumed to be purchased entirely from a retailer (rather than purchased directly from a producer), and therefore should include a retail margin (which adds between 9.7% -11.7% to the cost of UAFG) - what competitive tension exists in terms of suppliers of renewable or carbon neutral gas (relative to suppliers of fossil fuel gas) - Whether AGNSA would be required to purchase renewable gas under a long term contract that extends beyond the 5 years of the 2021 Plan.

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OPERATING EXPENDITURE ISSUES (CONT'D)

Step		Our Comments
Trending base year forward	👍	• Rate of change approach is consistent with regulatory precedent. • The annual input cost escalator of 0.5% would seem reasonable, although in light of COVID-19, wages increase assumption may need to be tested further towards the end of CY2020. • While we support the adoption of a productivity growth factor at the upper end of the range provided by the expert (ie 0.4% pa), given the 8% increase in opex being proposed for the first year of the 2021 Plan, the AER should satisfy itself that the factor should not align with the factor used by the AER for electricity businesses (ie 0.5%) including, by identifying differences in the technology and complexity of electricity and gas that may warrant a different factor being adopted by AGNSA.
Forecast of step change items = $8.1m during the 2021 Plan	☜	While it appears that the case has been made for step changes in insurance premiums and the proposed digital customer experience project, the AER should: - make further enquiries in relation to the proposal to include expenditure for the VCAP initiatives (see slides 16-17); and - give consideration to including changes in insurance premiums as part of the tariff variation mechanism (rather than just an insurance cap or credit risk event) so long as the base year is efficient.
Cost allocation methodology	☜	• We would expect the AER to make further enquiries to be satisfied that the cost allocation methodology appropriately allocates costs as a result of establishing AGIG in 2017 and to ensure that the full benefits of this new business have been passed on to AGNSA customers.

VULNERABLE CUSTOMER ASSISTANCE PROGRAM

- AGNSA proposes to adopt four initiatives to assist vulnerable customers reduce the financial barriers they face in utilising gas more efficiently and/or ensuring their appliances are operating in a safe and reliable manner (total cost ~$4m):
  - establish a dedicated vulnerable customer service role within AGNSA
  - implement an upgraded Customer Relationship Management (CRM) system that will include a priority services register
  - provide funding for safety checks and emergency repairs
  - provide rebates to help access more efficient appliances.
- While we recognise that these were developed following co-design workshops, we would encourage the AER to require a cost/benefit analysis be undertaken to determine whether it's more efficient to require retailers to expand on their existing programs rather than a network operator (such as AGNSA). The analysis should consider such issues as:
  - Who the customer interfaces with the most on vulnerability issues?
  - Are the current initiatives that AGNSA undertakes adequate?
  - Is there a double up between initiatives being undertaken by other organisations (such as retailers and charities) and those proposed by AGNSA?

VULNERABLE CUSTOMER ASSISTANCE PROGRAM (CONT'D)

- We would encourage the AER to consider whether all of the initiatives being proposed are the most appropriately targeted measures to assist vulnerable customers because:
  - How do the initiatives align with those that retailers already have in place?
  - Is the additional role overlapping to what might be achieved through the proposed upgraded CRM?
  - Could an existing CRM system already capture the information required for a priority services register?
- We would also encourage the AER to identify whether other initiatives, which might be more suited to vulnerable customers and which would appear to better align with the Energy Charter, have been considered such as:
  - Products and services that are tailored to vulnerable customers.
  - Training programs for frontline staff.
  - Further dispensation for disconnections if affordability issues arise.

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DEPRECIATION & ASSET LIVES

- AGNSA is not proposing any changes to its current approach to depreciation in response to the energy transition, instead preferring to wait for more information to become available on the role of gas in a low carbon future.
- While this approach is consistent with that followed by the AER for AGIG's other networks, and it is the approach we support (as it best aligns with the ECA's key objectives), it is not consistent with what is being proposed by Evoenergy in its 2021 plan – accelerated depreciation is being proposed.
- We have made submissions in response to the Evoenergy plan to not support Evoenergy's proposal. However, if the AER is inclined to support Evoenergy and apply that approach in respect of the AGNSA 2021 Plan, we would not support that for the reasons outlined in the following slides.
- There is no demonstrable increase in the risk of asset stranding compared to 2016 when this would have last been considered by the AER. In fact, new connections continue to increase during the 2021 Plan.

DEPRECIATION & ASSET LIVES (CONT'D)

- A more detailed cost/benefit analysis would need to be undertaken to assess the impact on today's and tomorrow's customers of the following scenarios:
  - Accelerating depreciation of existing and new long lived assets from 2021 onwards.
  - Accelerating depreciation of long lived assets from 2026 onwards.
  - Accelerating depreciation of new assets from 2021 onwards and for existing assets from 2026 onwards.
- Even if there is an increased risk of asset stranding, now does not appear to be the time to act to address it because:
  - The SA Government has not outlined any timeline for its roadmap to transition to its net zero 2050 aspiration. This should be known before taking pre-emptive action.
  - Because gas is a fuel of choice in SA, ensuring gas is as affordable as possible today maximises the incentives for continued asset utilisation . This maximises the likelihood of continued use of the network and minimises the risk that the asset may become stranded in the future.
- Furthermore, keeping prices as low as possible during the 2021 Plan period and waiting to re-assess the position on asset lives until the next re-set of 2026 will have other benefits:
  - It will give time to provide further clarity around alternatives to natural gas for the use of the network – if hydrogen can be commercialised and has a role to play in the network, any risk of asset stranding diminishes significantly and so there should be no need to make a change to asset lives at that point in time;
  - Any additional cost to "tomorrow's" consumers (ie those in the next 2026 Plan) will not be significant.

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DEPRECIATION & ASSET LIVES (CONT'D)

- While there is a forecast reduction in average usage and a decline in new industrial connections, AGNSA is forecasting increasing numbers of new residential (1% pa) and commercial (0.6% pa) customers by 2026. This was a critical issue relied on by the AER in the JGN 2020 reset for why shortening of asset lives was not allowed in that case.
- We would expect a cost benefit analysis to be undertaken to show the price impacts of deferring a decision on accelerated depreciation on new assets versus taking the action in this AA plan. Also, increasing prices for today's customers has a bigger impact now with the impact of COVID-19 on vulnerable customers.
- There are other options which the AER should consider such as:
    - Subsidies by government to the business to fully or partly address the impact; or
    - Creating a notional account so that the amount that would otherwise be included in the total revenue (by accelerating depreciation) is placed in it and so that it accrues interest over time. Should a viable renewable gas option be developed, the amount in the account gets added to the total revenue in subsequent years until the account is depleted.

OTHER BUILDING BLOCK ISSUES

- Forecast demand:
  - We support the continuation of the demand forecasting methodologies accepted by the AER for AGNSA's 2016 Plan and also the most recent Victorian reviews.
  - We would assume that the forecast demand associated with the extension to Mt Barker is based on the information used in the AER's final for this extension, with modifications to take into account any updates that have occurred since that decision.
- Forecast inflation – we encourage the AER to complete its current consultation process in relation to inflation in time for its position to be adopted in the Draft Decision.
- Price Path – while we support the upfront reduction of 6.5% (nominal).

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OTHER BUILDING BLOCK ISSUES (CONT'D)

- Financeability of pricing decision
  - AGNSA claims that its proposal will deliver an average FFO to debt outcome of 9% that will just be sufficient to maintain a weighted average credit rating of between A- and BBB+.
  - We would expect the AER to test this and to focus on a number of factors, including:
    - The extent to which other revenue earned by AGNSA is factored into this assessment (in addition to reference service revenue) – eg revenue from the application of any incentive mechanisms.
    - The tax treatment to be adopted in this analysis – noting that "FFO" is revenue less opex and tax.
    - How AGN's actual financing arrangements are structured.

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RESPONSE TO INCENTIVE SCHEMES

INCENTIVE MECHANISMS

- AGNSA is proposing to continue the EBSS for opex that exists in the 2016 Plan. We note that the AER proposed modifications to the standard EBSS in the JGN 2020 Plan. It is not clear if these modifications are to be applied to the 2021 Plan for AGNSA.
  - If they are being incorporated in the 2021 Plan, we would support these modifications.
  - If they are not being incorporated, the AER should inquire why not.
- The proposed Capital Expenditure Sharing Scheme (CESS) is intended to mirror the Contingent CESS that was approved by the AER for the Vic AGN Plan (including the API measures, targets and weightings). This is different to the CESS that was approved by the AER in the JGN 2020 Plan. We note that the JGN decision was only just before the AGNSA plan was submitted and we would therefore encourage ongoing engagement to align with the CESS in JGN.
- There is a proposal to introduce a network innovation scheme/allowance that would allow between $2.5m - $5m in costs over the 2021 Plan. But the details have yet to be outlined. Before ECA could support such a scheme, it would need to be satisfied that other mechanisms outside of the NGL (eg ARENA funding) aren't sufficient to incentivise the adoption of the type of innovation projects being considered.

OTHER ISSUES RAISED BY AGNSA'S 2021 PLAN

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COVID 19 IMPACTS

- AGNSA has indicated that many of their inputs into their operx forecasting methodology (such as HIA forecast of housing starts and BIS Oxford's forecast of real labour cost escalation) already take into account the impact of COVID-19. However, we think that there is a real risk that COVID is still evolving and therefore the forecasts may require updating at the time of the draft decision if there is a better understanding of the impact of COVID-19 on these forecasts at the time.
- This raises a potential procedural fairness issue for consumers, particularly if the COVID related adjustments are substantive in nature.
- It means that while consumers will be able to make submissions on the revised proposals that the businesses submit, they will not have an opportunity to make submissions on the AER's thinking on the COVID related adjustments because this will only be outlined in the Final Decision. But the process under the NGR does not prescribe for consultation in response to the AER's final decision.
- AER should give consideration to how procedural fairness is afforded to consumers – options include:
  - Option 1 - the AER could require any COVID related adjustments to be submitted by the businesses prior to the Draft Decision and open up a round of mini consultation on these adjustments before the draft decision is issued. Then the AER's draft decision can take into account both the COVID related adjustments and any submissions consumers make in response.
  - Option 2 – the AER could maintain the status quo until after submissions have been received in response to the revised proposal submitted in response to the Draft Decision. The AER could then issue a preliminary position paper on the COVID related adjustments and request submissions from consumers on its position. Following consideration of these submissions, the AER would then make its final decision.

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