[redacted]

10 July 2019

Economic Regulation Authority
PO Box 8469
PERTH BC WA 6849

via email to: publicsubmissions@erawa.com.au

Dear Ms Cusworth

SUBMISSION TO THE ECONOMIC REGULATION AUTHORITY'S DRAFT DECISION ON PROPOSED REVISIONS TO THE MID-WEST AND SOUTH-WEST GAS DISTRIBUTION SYSTEMS ACCESS ARRANGEMENT FOR 2020 TO 2024

Synergy welcomes the opportunity to make a submission in response to the Economic Regulation Authority's (**ERA**'s) Draft Decision on ATCO Gas Australia's (**ATCO**'s) fifth access arrangement (**AA5**) proposal covering the Mid-West and South-West gas distribution systems over the five years to 2024.

This submission is provided to assist the ERA in making an informed decision in relation to ATCO's AA5 access arrangement review process. It reflects on key aspects of the ERA's Draft Decision and ATCO's 2020-24 Revised Plan (**Revised Plan**).

<u>Overarching comments</u>

From Synergy's perspective the ERA's Draft Decision is a well-considered and balanced response to ATCO's expenditure forecast and pricing proposal.

Synergy's overarching feedback to the ERA on ATCO's Revised Plan is that it remains unsubstantiated, and therefore the ERA's Final Decision should remain largely unchanged from its Draft Decision. From the information provided publicly, it is not clear to Synergy how ATCO has substantiated its forecast or historical expenditure to any greater extent than it did in its initial proposal.

In many instances, ATCO's response to customer feedback is that it has made 'no change to the 2020-24 Plan', and purports to have provided additional evidence (in the form of CEARs and business cases) to support its proposal. However, little or none of this additional evidence has been made available to customers.

Synergy considers any outcome that results in price shock to the end use customer is not in the long term interests of consumers, and therefore contrary to both section 26(1) of the ERA Act 2003, and the pricing principles in section 24(5) of the National Gas Law (**NGL**).

From the end use customer's perspective setting any price increases over the AA5 period to a reasonable and justifiable amount is important. However, it also is important that any price increases are the result of applying carefully considered and justified adjustments to each of the revenue building blocks that drive the price path, and that price outcomes are not too heavily weighted on any single revenue parameter (particularly where the regulated business' ability to control that parameter is limited). Balancing adjustments across several building blocks helps promote sustainable costs over the longer term, as it affords greater flexibility and opportunity to manage prices in the future.

This balanced approach was applied by the ERA in its Draft Decision. In Synergy's opinion the ERA's Draft Decision meets the National Gas Objective (**NGO**), which is:

> *to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.*

The Draft Decision included reduced tariffs to increases of 7.56% in 2020 and 2.3% in subsequent years (all tariffs). This was largely driven by:

- a reduction in forecast capital expenditure (**capex**) from $509.3 million to $239.8 million;
- a reduction in forecast operating expenditure (**opex**) from $357.4 million to $320.9 million; and
- a reduction of the rate of return (vanilla nominal post-tax weighted average cost of capital) from 6.03% to 5.70%.

Synergy supports the Draft Decision. It considers the reduced tariff increase to be reasonable, with the revised step change quantum in the first year of AA5 (7.56%) reflecting that 2019 tariffs that were set below the expected cost of service for that year.

In its Revised Plan, ATCO proposes tariff increases of 10.6% in 2020 and 2.3% in subsequent years. This is not significantly different from the ERA's Draft Decision. However, rather than being as a result of a conscious effort by ATCO to modify its plans to reflect stakeholder concerns and price shock, ATCO's revised pricing proposal results from a materially reduced rate of return of 4.87%. Synergy notes that ATCO seeks to reinstate $24.2 million of opex and $197.2 million of capex, which was disallowed by the ERA in its Draft Decision.

As discussed above, it is important price outcomes are the result of balanced adjustments across all revenue building blocks and that regulated businesses should attempt to reflect stakeholder feedback within commercial reason.

Synergy is concerned ATCO appears to have not addressed the underlying drivers of the price increases identified by stakeholders and the ERA. It has instead relied on a reduction in the rate of return driven solely by the fall in market conditions, which as highlighted by ATCO[1] will necessarily change as it is set at the time of the ERA's Final Decision.

Synergy and other stakeholders were clear in their submissions to the ERA's Issues Paper[2], the expenditure proposal (not just the resulting prices and price path) was not supported by adequate information in relation to how it met the expenditure tests in rules 74, 79 and 91 of the National Gas Rules (**NGR**).

Synergy understands ATCO provided its Revised Plan for publication during the ERA's consultation on the Draft Decision to allow stakeholders to consider this information in developing submissions. However, ATCO has redacted critical information, meaning that in many circumstances stakeholders are unable to develop an informed opinion about key elements of the proposal (for example, historical capex). This limits stakeholder scope to assess ATCO's Revised Plan.

ATCO's broad confidentiality claim on all redacted information in the access arrangement information states the information contains market sensitive cost inputs as follows[3]:

> *The document contains detail on actual and forecast costs of undertaking works. Publishing the material will prejudice future tender and commercial negotiation processes between ATCO and current and potential contractors/suppliers.*

ATCO claims *"[p]ublic disclosure of this information will undermine the request for quote, request for tender and negotiating strategies to achieve efficient costs"*, and that *"[d]isclosure could therefore harm ATCO's ability to obtain competitive prices in future transactions and, ultimately, increase costs passed on to customers"*.

Synergy understands sensitive information (for example, contractual terms or information on reduced staff levels) should remain confidential. However, Synergy does not consider ATCO has clearly explained how public disclosure of actual and forecast costs "*could cause undue harm to the legitimate business interests of the service provider, a user, or prospective use*r", as required by rule 43(2) of the NGR.

This type of information is disclosed publicly in most other regulatory determinations[4] without detriment to those service providers. Further, a service provider's formal procurement,

---

1 Page 200, AA5 AAI Revised Submission – PUBLIC, ATCO, 12 June 2019.

2 See for example page 1 of AGL Energy's submission, page 3 of Kleenheat's submission, and page 3 of Synergy's submission, available at: https://www.erawa.com.au/gas/gas-access/mid-west-and-south-west-gas-distribution-systems/access-arrangements/access-arrangement-for-period-2020-2024.

3 Page 10, Document Index and Confidentiality Claims, ATCO, 12 June 2019, available at: https://www.erawa.com.au/cproot/20500/2/01.102-Document-index-and-Confidentiality.PDF.

4 For all regulatory determinations made by the Australian Energy Regulator under the NGR, a Regulatory Information Notice (RIN) is required to be produced by each network business, which provides more granular

budgeting and investment governance procedures should be sufficient to counter any perceived bias or exposure resulting from a high-level expenditure forecast provided for the purpose of setting reference service tariffs.

Historical and forecast expenditures are critical information, without which stakeholders cannot be expected to make an informed decision on whether or not ATCO's Revised Plan meets the requirements of rules 74, 79 or 91 of the NGR.

Under subsection 26(1)(g) of the ERA Act 2003, the ERA must have regard for *"the need to promote transparent decision-making processes that involve public consultation an open and transparent consultation process"*. Synergy considers this element of transparency is critical to enable network users (and end customers) to determine whether ATCO's Revised Plan in its response to the Draft Decision achieves the NGO. Diluting this level of transparency has potential to reduce the effectiveness of the access arrangement review process.

To this end, Synergy does not consider that the new information provided by ATCO and made publicly available is adequate to allow stakeholders to determine whether various elements, and therefore the resulting price should be considered inconsistent with the NGO.

Synergy's comments on specific elements of the ERA's Draft Decision and ATCO's Revised Plan are provided in the following sections.

Rate of return

In determining the revised rate of return, ATCO has re-estimated the market driven parameters[5] using market data to 30 April 2019.

Synergy notes the change in market driven parameters – specifically reductions in the risk-free rate results in a reduction in the rate of return from 5.70% to 4.87%. These reductions in-turn result in lower prices and are to the benefit of gas users. Notwithstanding the change in market conditions, ATCO must demonstrate and the ERA must assess whether the revised rate of return included in ATCO's Revised Plan meets the NGO.

As ATCO highlights, these values used are only a placeholder and ATCO will *"…separately nominate a confidential sampling period to be applied for the purposes of the Final Decision…"*[6]. As such, the forecast reduction in prices proposed by ATCO, with no other material change made by ATCO in response to the Draft Decision, is also a placeholder price path, and will ultimately be influenced by the final rate of return market driven parameters. In the absence of any material change in other revenue building blocks as was required by the ERA in its Draft Decision:

- the price path proposed by ATCO remains higher than the ERA's Draft Decision;

information that what has been claimed confidential by ATCO and redacted. Further, network business provide public copies of relevant business cases as a matter of course.

5 The updated parameters are the risk-free rate, bank bill swap rate and inflation rate.

6 Page 200, AA5 AAI Revised Submission – PUBLIC, ATCO, 12 June 2019.

- the return of market parameters back to a level similar to that included in ATCO's initial proposal will result in a tariff path significantly higher than the untenable levels originally proposed by ATCO; and
- an increase in market parameters has the potential to increase the prices well beyond levels commonly associated with price shock for multiple years of the AA5 period.

Forecast capital expenditure

In its Draft Decision, the ERA required a ~$270 million reduction in forecast capex from that proposed by ATCO. This was driven by significant reductions in both network growth capex and sustaining capex. Synergy supports the ERA's Draft Decision on the basis AA5 did not adequately demonstrate these aspects of the forecast capex meet the requirements of rules 74 and 79 of the NGR.

ATCO's Revised Plan does not address stakeholder concerns on the prudence or efficiency of the expenditure either at an expenditure category level, or specific project level. This is largely as a result of much of the information being contained in business cases and capital expenditure approval requests that have not been made publicly available as the result of a confidentiality claim.

As previously noted, this approach is inconsistent with requirements of the NGR, regulatory best practice, standard practice by gas network businesses regulated under the NGR on the east coast of Australia, and other network businesses regulated by the ERA.[7]

Due to ATCO's confidentiality claims, Synergy does not have the level of detailed information needed to provide an informed opinion on specific projects and programs that should be included in ATCO's AA5. However, it is clear that ATCO's capex has increased substantially in recent years, with AA4 and the revised proposed capex for AA5 being considerably higher than prior periods but against a backdrop of reduced demand.

ATCO is forecasting the number of new connections over AA5 will be fewer than the number over the previous five-year period (2015 – 2019). In addition, the average demand per connection is declining. Notwithstanding this ATCO's Revised Plan seeks to reinstate ~ $200 million of this expenditure. Synergy recommends the ERA to reconcile this apparent discrepancy.

Synergy highlights that the capex forecast is contributing materially to prices not just in AA5, but in many future regulatory periods as depreciation on this expenditure. Synergy recommends the ERA consider the justification for each of the key projects, assessing the forecasting methodology used to determine project costs, benchmarking and market testing unit rates for volumetric programs of work, and assessing the deliverability of the work plan based on recent performance. It is critical the ERA undertakes this work, as stakeholders have not been afforded the opportunity to provide a view through this consultation process.

7 Common practice is to publish historical and forecast expenditures, and more importantly make business cases publicly available as part of the access arrangement review process, with the exception of specific project forecast costs or unit rates.

Forecast operating expenditure

In its Draft Decision, the ERA required a ~$40 million reduction in opex from that proposed by ATCO. This was driven by a required change to the base year to reflect the most recent year of actual opex (2017), the reduction of cost escalation and the removal of various un-justified step changes.

The ERA's Draft Decision results in only a modest 3.3% average annual increase when compared to the AA4 actuals (2015-2017). This is more in line with the level of opex growth Synergy would expect to see for a gas distribution network with a significant recent network renewal program, and low forecast demand growth.

Synergy supports the reductions made in the ERA's Draft Decision, as ATCO did not adequately demonstrate these aspects of the forecast opex meet the requirements of rules 74 and 91 of the NGR.

ATCO's Revised Plan re-introduces ~$25 million of opex costs the ERA disallowed in its Draft Decision. This is largely the result of the change in base year from 2017 (used in the Draft Decision) to 2018. The impact of ATCO's revisions is an 11.4% average annual increase over AA4 actuals to date (2015-2018), or 13.8% once ancillary services and unaccounted for gas are excluded. This is a material increase that Synergy considers is inconsistent with a network provider seeking to achieve the lowest sustainable cost of delivering pipeline services, and therefore the NGO.

In its Revised Plan, ATCO has identified and described each of the increases between the 2017 opex assessed in detail by the ERA, and the new proposed 2018 base year. The change in base year from 2017 to 2018 inflates opex to be rolled forward to each of the five years by ~$3 million per annum, which accounts for the majority of ATCO's increased revised proposed opex forecast.

Synergy recommends the ERA maintains its Draft Decision to use 2017 as an efficient base year for the purposes of its Final Decision because:

- conducting a detailed assessment of yet another year of opex is an inefficient use of the ERA and stakeholders' time, but would need to be undertaken to ensure the resulting opex forecast meets the requirements of rules 74 and 91 of the NGR. Synergy considers the ERA's analysis of 2017 is a reasonable forecast and sufficient to meet the requirements of the NGR;
- there are likely to be negative step-changes that ATCO has not yet identified, which would need to be assessed and be offset against the identified increases; and
- using 2018 actual opex is unlikely to result in a materially different opex forecast.

Synergy considers the ERA's Draft Decision in relation to ATCO's proposed step changes and output growth escalation are also appropriate, as ATCO has not adequately justified the need for the increases, and in some instances has failed to demonstrate that these cost categories should be recovered from customers through regulated revenue.

Synergy notes the ERA has not applied an efficiency dividend to ATCO's opex forecasts in its Draft Decision, on the basis that:

- the scale of ATCO's operations is not forecast to increase over AA5, and thus it is unlikely that ATCO will see increasing economies of scale; and
- most of ATCO's proposed AA5 capex is for network sustaining and network growth projects and structures and equipment, rather than strategic projects to enhance productivity / efficiency of operations or reduce operating cost structure. It is thus unlikely that ATCO will increase productivity through technological developments.

In its Revised Plan, ATCO states that *"We do not believe that a productivity adjustment is in the best interests of customers as it would likely yield adverse implications for our ability to provide a safe and reliable natural gas service…"*[8] and that *"… application of an arbitrary productivity adjustment would not necessarily achieve a sustainable cost of delivering pipeline services…"*[9].

Contrary to ATCO's view, Synergy considers:

- the inclusion of a productivity adjustment is not inconsistent with the requirement to provide a safe and reliable natural gas service under NGR 74 and 91;
- the absence of strategic projects to enhance productivity / efficiency in AA5 does not necessarily mean that there are no efficiencies available to ATCO - this is supported by several statements in its draft AA4 submission where ATCO notes efficiencies to be gained through implementation of parts of its forecast capex program[10]; and
- the absence of strategic projects to enhance productivity / efficiency in AA5 does not necessarily mean that there should be such an absence, or that no possible further operational or administrative efficiencies are available.

ATCO also considers a productivity adjustment is not required because it is absorbing $2.6 million of network related step changes. Synergy considers absorbing cost increases is not tantamount to a productivity improvement, rather it can infer inadequate forecasting and/or cost management.

As such, Synergy recommends the ERA reconsider the imposition of an efficiency dividend to ensure that ATCO operating costs do not simply continue to increase in real terms, imposing additional fees on network users and end customers. This is particularly important if the ERA chooses to reinstate forecast expenditure it disallowed in its Draft Decision.

8 Page 89, AA5 AAI Revised Submission – PUBLIC, ATCO, 12 June 2019.
9 Page 124, AA5 AAI Revised Submission – PUBLIC, ATCO, 12 June 2019.
10 Including in particular, AA5 upgrades to IT systems, including SAP, and significant investment in SCADA and remote control capability.

Other matters

ATCO is proposing the ability to recover the development rebate scheme costs through reference tariffs in future access arrangement periods. The ERA should consider the appropriateness of this request and whether it is consistent with the NGO.

Synergy confirms that this submission can be made publicly available. Should you require further information regarding any of the comments made in this submission, please contact me.

Yours sincerely

[redacted]

SIMON THACKRAY
MANAGER REGULATION AND COMPLIANCE