

16 April 2015

Via email

Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Level 20
111 Pacific Highway
North Sydney NSW 2060
PO Box 1220
North Sydney NSW 2059
T +61 2 9455 1500
F +61 2 9455 1589
www.jemena.com.au

Dear Mr Roberts

JGN 2015-20 access arrangement – Origin Energy and EMRF submissions

Submissions made by Origin Energy and the Energy Markets Reform Forum (**EMRF**) on the AER's draft decision for Jemena Gas Networks (**JGN**) have raised concerns regarding JGN's proposed B2B harmonisation cost forecasts and return on equity proposals respectively.¹

Given the short timeframe before the AER makes a final decision for JGN, I thought it would be helpful to directly address these concerns in writing.

Origin's submission on B2B harmonisation costs

In summary, Origin's concerns relate to:

- the prudence and efficiency of our additional IT capex proposal, including the web portal
- the degree of any inter-relationship with this IT capex and the GASS+ replacement project already approved by the AER in the JGN draft decision
- why our costings differ to those included in the 3 July 2014 Nous Group report to AEMO.

On the first point, we note that we have provided detailed capex and opex information to the AER associated with implementing and complying with the new B2B and B2M obligations.² This information provides line-item costings for all capex and opex components, and descriptions of the nature of the activity driving the different costs.

¹ Origin Energy, *Australian Energy Regulator's Draft Decision and Jemena Gas Networks' Revised Access Arrangement Proposal – submission to the AER*, 27 March 2015 pp. 5-7; EMRF, *Draft decision by the Australian Energy Regulator on Jemena's Gas Network Access Arrangement – a response by EMRF*, March 2015, section 4.

² JGN, *Response to the AER's draft decision and revised proposal – addendum – B2B harmonisation capex and opex proposal*, 23 March 2015

These forecasts reflect the lowest sustainable costs of delivering on these new market requirements from April 2016.

We can also confirm that we have been transparent in briefing the NSW market about our intention to introduce a service portal as part of the broader IT changes. The design for this portal will largely replicate the Jemena Electricity Networks portal that is currently operational and in use by Origin Energy. Jemena has undertaken that it will engage further with retailers including Origin Energy about the portal design and proposed use.

On the second point, we can also confirm that the IT capex included for B2B harmonisation only reflects *incremental* capex associated with delivering the changed IT infrastructure necessary to comply with the new market obligations. At the time our 30 June 2014 expenditure forecasts were developed, costing models to capture the new obligations were still being prepared. This is made clear in the IT Asset Management Plan (**IT AMP**) we submitted with our initial proposal on 30 June 2014.³

Thirdly, as Origin Energy would know, the incremental changes to B2B and B2M obligations were agreed with the market after the Nous Group report was finalised in July 2014. The Nous Group report reflected initial and high-level scoping documents only⁴. Due to timing, the Nous Group report is not a reliable reference point for detailed and robust costing estimates that reflect the actual scope of the final market obligations determined by AEMO.

EMRF submission on the return on equity

The EMRF considers that we have presented an unnecessarily complex approach to estimating the return on equity that leads to that return being overstated. The EMRF advocates for what it sees as a more common sense approach—whereby market-based evidence is placed at the forefront of the determination over what the EMRF considers to be a theoretical approach of JGN.

However, the EMRF falls short of showing how a more applied approach can be implemented to arrive at the return on equity. It simply asserts that the return on equity put forward by JGN is clearly too high in light of actual market outcomes, but without referencing the relationship between those market outcomes and the return on equity.

Our approach considers relevant evidence on its merits and weights this together, transparently, to arrive at an estimate of the return on equity.

The EMRF also characterises our approach as theoretical—which is also not true. We rely extensively on analysis of market prices and returns to reach decisions based upon empirical evidence, not theories.

Our approach combines both theory and market evidence, recognising the strengths and weaknesses of each. Most importantly, we recognise the empirical failings of the Sharpe-Lintner capital asset pricing model by augmenting return on equity estimates from this model with those from others.

Finally, the EMRF also characterises our approach of using weights to reach decisions as non-transparent and inconsistent. This is also false. The AER uses the same

³ JGN, *2015-20 access arrangement information*, 30 June 2014, appendix 6.3, pp. 21-22.

⁴ As noted in briefing documents provided to the AER: JGN, *2015-20 response to the draft decision and revised proposal*, 27 February 2015, appendix 1.7 (JGN presentation for AER meeting 29 Jan 15).

underlying approaches to reach decisions on the return on equity, but with less clarity on how information is used. The weight allocated to different pieces of information can vary amongst different experts and over time—but that variation merely reflects the reality that the implications of different information is not perfectly clear.

Reaching conclusions simply by writing down the final answer does not make the approach more transparent and consistent when compared to an alternative approach that writes down *how* this answer is derived directly from relevant evidence.

Attachment A provides further detail on our response to the EMRF submission on the return on equity.

We trust that this information comprehensively addresses the EMRF and Origin Energy submissions on these matters. Please feel free to contact Alex McPherson on (02) 9867 7229 or at alex.mcperson@jemena.com.au if you would like to discuss these matters further. I am happy for this letter to be published on the AER's website.

Yours sincerely

A handwritten signature in black ink, appearing to read 'R. McMillan', with a stylized flourish at the end.

Robert McMillan
General Manager Regulation
Jemena Limited

Attach: Review of EMRF submission on the return on equity