



13 July 2015

Mr Chris Pattas
General Manager - Network Investment and Pricing
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Dear Mr Pattas

RE: SUBMISSION TO VICTORIAN ELECTRICITY DISTRIBUTORS REGULATORY PROPOSALS

Origin Energy Electricity Limited (ABN 33 071 052 287, "Origin") appreciates the opportunity to provide a response to the regulatory proposals lodged by the Victorian distribution network service providers with respect to the determination of regulatory revenue allowances for the period 2015 to 2020.

The AER's assessment will be the first application of changes to the National Electricity Law and National Electricity Rules to the Victorian businesses. In this regard, we support the AER's use of benchmarking techniques as provided for under the Rules to determine operating and capital expenditure allowances.

While the Victorian businesses have proposed forecast revenue allowances that provide reductions in network tariffs over the regulatory period, we consider a number of additional efficiencies can be achieved in the proposed step change operating costs. In addition, we consider that the proposed classification and costs put forward by a number of the business with respect to advanced metering requires further scrutiny.

With respect to capital expenditure, we also consider that the AER must continue to apply technical assessments in concert with its benchmarking techniques to ensure a prudent balance between asset risk and input costs.

In terms of the proposed weighted average cost of capital (WACC), Origin considers that the approach proposed by the businesses seeks to lock-in higher returns on debt than is reasonable as well as adopting inflated equity betas. We consider that the AER has adopted a balanced and pragmatic approach to WACC in previous decisions and encourage an extension of that approach for its assessment of the Victorian businesses.

If you have any questions regarding this submission please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

A handwritten signature in blue ink, appearing to read "K. Robertson".

Keith Robertson
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*Response to Victorian NSW DNSPs Regulatory Proposals for
the regulatory control period 2015 to 2020*

Origin Submission

July 2015

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1 Opex

1.1 Summary

- Support the application of a benchmark efficiency threshold of the average of the top quartile.
- Support the AER assessing step change costs consistently across jurisdictions.
- Seek further clarity regarding the classification and treatment of AMI Cost Recovery Order-in-Council (CROIC) costs.
- Do not support the inclusion of costs associated with capitalisation changes.
- Consider the rate of change proposed by Powercor and Citipower requires further scrutiny.

1.2 Proposed Operating Expenditure

A summary of the operating expenditure (opex) proposed by the Victorian DNSPs is reproduced in Table 1.

Table 1: Victorian DNSPs Proposed Opex 2016-20 (\$m real 2015)

Category	Ausnet	Citipower	Powercor	Jemena	United
Base	913.0	294.4	907.6	379.2	623.9
Base Adj	-	11.5	33.4	-	81.6
Step Changes	5.0	18.3	16.5	25.7	53.8
Change in Capitalisation	-	94.8	173.4	-	-
Service Reclassification	-	19.5	43.3	63.9	-
Specific Forecasts	-	-	-	5.9	-
One-off costs	-	-	-	(9.8)	-
Insurance	79.0	-	-	-	-
GSL	28.0	-	-	-	5.7
DMIS/DMIA	10.0	-	-	-	6.6
Debt Raising	-	-	-	-	13.7
Rate of Change	88.0	65.5	159.6	34.1	15.1
Total	1,256	502.0	1,333.7	499.01	800.4

The AER method to assess proposed base opex is set out in its Expenditure Forecast Assessment Guideline. To date, the AER has adopted the following process:

- develop a raw efficiency score applying the AER's preferred economic benchmarking model;
- compare the raw efficiency scores of the businesses with the AER determined benchmark comparison;
- adjust the efficiency benchmark to take account of operating environment factors; and
- adjust the results to account for trending the opex to a relevant starting date.

For its Final Determination for NSW and its Preliminary Decision for South Australia and Queensland, the AER considered that it was appropriate to adopt a cautious approach and to incorporate an appropriately wide margin for potential modelling and data errors.¹ As a result, the AER applied a

¹ AER, Preliminary Decision, Energex determination, Attachment 7 – Operating Expenditure, p. 25.

benchmark based on the lowest of the efficiency scores in the top quartile of possible scores. This departed from its earlier approach to adopt the average of the top quartile.

In our response to the AER's Draft Determination for NSW, we stated our support for the AER's decision to recognise general limitations of the benchmarking model. However, we maintain our position that an appropriate benchmark comparison is the AER's original position of the average of the top quartile, especially when operational environment factors are also included.

In setting out its draft decision for the Victorian businesses, we also believe it is essential that the AER adopt an approach that identifies each quantitative adjustment in its analysis, as it has done with its decision for Queensland. This will not only provide stakeholders with the opportunity to make direct comparisons across the businesses and jurisdictions, but it will also assist in improving stakeholder's knowledge of the approach which will make for more informed submissions in the future.

We note that the DNSPs have adopted 2014 as the base year as it represents the most recent actual audited reported performance that will be available before the AER is required to make its Draft Decision. We encourage the AER to adopt a consistent approach across jurisdictions to determining the base year opex.

Adjustments and Step Changes

The Victorian DNSPs have included a number of items in their respective base adjustments and step changes that the AER has already set a precedent.

These include cost increases associated with insurance, regulatory reporting, submission preparation and superannuation. The DNSPs have also included significant cost increases associated with the reclassification of services and cost allocation adjustments.

The AER's position is that step changes should generally relate to a new obligation or some change in the DNSP's operating environment beyond its control. It is not enough to simply demonstrate an efficient cost will be incurred for an activity that was not previously undertaken.

Furthermore, the AER has previously determined that an efficient base level of opex is sufficient for a prudent and efficient service provider to meet all existing regulatory obligations. In its decision for NSW it cites the example of insurance premiums:²

A step change is not required if insurance premiums are forecast to increase faster than CPI because within total opex there will be other categories whose price is forecast to increase by less than CPI. If we add a step change to account for higher insurance premiums we might provide a more accurate forecast for the insurance category in isolation; however, our forecast for total opex as a whole will be too high.

Origin considers that the AER should apply a consistent approach to the assessment of the step change and base adjustment costs of the Victorian businesses. Origin considers that the approach the AER has taken to date ensures only efficient costs are included in the forecast allowances and removes the potential for double counting.

Changes in Capitalisation

Powercor and Citipower have made a number of adjustments to their proposed opex to account for changes to their capitalisation policy. These changes result in an increased allocation to opex of \$173.4 million or 13% for Powercor and \$94.8 million or 19% for Citipower.

The DNSPs state that the result of the increase is attributable to the expensing of indirect corporate overheads under its revised cost allocation method (CAM). They argue that this represents a

² AER, Ausgrid determination, Attachment 7 – Operating Expenditure, p. 294.

reallocation of costs, rather than any new costs and that this has not changed the combined total of the capital and operating expenditure forecasts for standard control services.³

We note that in the AER's decision for Essential Energy, it did not allow a step change for overheads allocated to opex that were previously allocated to both opex and capex.⁴

We are concerned that changes to a business' CAM can result in significant and material changes in allocation of costs to opex and capex, which in turn has direct revenue implications. Notwithstanding the AER's approach to benchmarking seeks to isolate the impact of changing cost allocations, we remain concerned at allocations of this magnitude and consider these costs require further scrutiny to fully understand how they impact on benchmarking and revenue outcomes.

For these reasons, we consider it is imperative that the AER closely scrutinise the basis of the change in allocation and to ensure that, where practicable, a consistent approach is applied to allocation of overheads across businesses.

Reclassification of Costs

The Rules require the AER to regulate smart meters and their associated equipment in the first year of the next regulatory control period under the form of regulation which applies under the AMI Cost Recovery Order-in-Council (CROIC).

The AMI CROIC includes provision for exit and restoration fees. The AMI CROIC also establishes a framework for regulating AMI metering which includes an individual price for meters serving customers in the same customer class.

In classifying a service the AER has stated that it must, where there is no previous classification of the service, have regard to the previously applicable service classification. As a result, it has decided to classify services previously captured under the AMI CROIC as an alternative control service and to apply a revenue cap as the form of control.

We understand that a number of the DNSPs have included costs associated with the AMI CROIC as standard control service costs (namely Powercor and Citipower). As a result, these costs will be recovered through network use of system charges.

One of the key aspects of the AER's previous decision with respect to metering was having transparent standalone prices, the desirability for consistency between regulatory approaches and the removal of cross-subsidies.

Origin is concerned that if metering activities are classified as standard control services and recovered through network charges this will result in cross-subsidies and would not be consistent with a framework that would support the expansion in metering and related services.

For example, in the event that a customer obtains a new meter (i.e. the construction of a new premises), if metering costs are included in network charges these customers will pay for services they are not receiving. This is the very cross-subsidy AER's decision to date have sought to eliminate.

For these reasons, we support the AER adopting an approach to the classification and treatment of metering costs that is consistent with its metering decisions for NSW, South Australia and Queensland.

³ Powercor, Regulatory Proposal, p. 174.

⁴ AER, Essential Energy, Attachment 7 – Operating Expenditure, p. 289.

2 Forecast Capex

2.1 Summary

- Support the AER assessing the appropriateness of the risk assessment approaches of the DNSPs to ensure that they are not overly conservative and that expenditure is adequately linked to a prudent needs-driven analysis.
- Seek clarification on the consistent application of the AEMO Value of Customer Reliability (VCR) valuation of reliability.
- Consider ICT costs are persistently high and warrant further investigation.

2.2 Proposed Capital Expenditure

A summary of the capital expenditure (capex) proposed by the Victorian DNSPs is reproduced in Table 2.

Table 2: Victorian DNSPs Proposed Capex 2016-20 (\$m real 2015)^A

Category	Ausnet	Citipower	Powercor	Jemena	United
Augmentation	313.8	179.9	242.6	182.7	166.5
Connections	368.2	332.1	774.1	227.8	249.1
Replacement	900.7	260.0	664.7	293.5	585.1
Network Overheads	116.5	93.5	202.3	-	-
Corporate Overheads	56.2	-	-	-	-
VBRC	-	9.2	141.0	-	-
ICT	-	81.1	175.3	101.9	163.7
Non-Network	-	36.5	122.3	35.3	30.9
Equity Raising	-	2.3	9.2	-	-
Gross Capex	1,964.0	995.3	2,331.4	841.2	1,195.3
Less Cap Cons	274.0	144.9	316.0	-	91.4
Net Capex	1,690.0	850.4	2,015.4	841.2	1,103.9

^A Taken from the business' regulatory proposals

The levels of capex proposed by the DNSPs represent a moderate increase relative to actual expenditure in the 2011-15 regulatory period. A main driver of the proposed increases is replacement expenditure (repex). For example, Jemena is proposing a 70% increase relative to the actual spend over the previous regulatory period⁵ while United Energy is proposing a 33% increase.

A common theme across the businesses is the need to maintain levels of service in the face of ageing and deteriorating assets. They argue, namely United Energy, that there is a strong correlation between the age of an asset and the contribution to SAIDI from equipment failure.⁶

Equally, Powercor and Citipower also provide evidence of increasing power line failure rates.⁷

We recognise that each of the DNSPs have adopted various asset management approaches to determine their forecast expenditure. Each of these involves assumptions regarding asset condition, asset performance and risk failure.

⁵ Jemena, Regulatory Proposal, p. 73.

⁶ United Energy, Regulatory Proposal, p. 47.

⁷ Powercor, Regulatory Proposal, pp. 111-112.

We also note that the DNSPs have also validated their forecasts using the AER's repex and augex models.

The AER's models produce a range of estimates that are driven by different replacement ages and unit cost inputs. For this reason we consider that the AER has a crucial role in assessing the appropriateness of risk assessment approaches to ensure that they are not overly conservative and that expenditure has not been adequately linked to a prudent needs-driven analysis.

We also support the application of both a top down and bottom up approach to demonstrate that a level of overall restraint has been brought to bear. This dual exercise is necessary to ensure that forecast costs, including unit rates, have not been overstated and that inter-relationships and synergies between projects or areas of work which are more readily identified at a portfolio level are adequately accounted for.

We note that the DNSPs have relied heavily on the AEMO VCR valuation to support expenditure on the basis it delivers reliability that is consistent with customers' expectations. We consider it prudent for the AER to satisfy itself that the DNSPs have applied the VCR analysis in a manner that ensures a consistent interpretation of reliability both across the businesses and over time.

We are also concerned at the persistent high levels of ICT expenditure relative to expenditure over the period 2012 to 2015 and consider these require further scrutiny.

As raised in the section on opex, we are concerned about the future classification of metering services. We consider that the AER needs to scrutinise the proposed capex costs to ensure the appropriate allocation of AMI costs between alternative and standard control services consistent with its service classification.

3 WACC

3.1 Summary

- Do not support the proposed Market Risk Premium (MRP). Consider the AER method is preferable and provides a certain and predictable outcome for investors and a balance between the views of consumer groups and the businesses.
- Do not support the equity betas proposed by the business. Maintain support for the AER equity point estimate of 0.7.
- Do not support immediate application of the debt risk premium to the trailing average approach.

3.2 Overview

The proposed parameter values and subsequent rates of return submitted by the Victorian DNSPs are presented in table 3. For completeness, the AER's approved parameters for the NSW DNSPs is also provided.

Table 3: Victorian DNSP Proposed WACC parameters

Category	Ausnet	Citipower	Powercor	Jemena	United	AER
Equity Beta	0.89	0.82	0.82	0.89	0.82	0.70
Risk free Rate %	2.64	2.64	2.64	2.50	2.64	2.55
Market Risk Premium	8.17	8.17	8.17	8.17	8.17	6.50
Gamma	0.25	0.25	0.25	0.25	0.25	0.40
Return on Equity %	9.87	9.90	9.90	9.87	9.95	7.10
Credit Rating	BBB	BBB	BBB	BBB	BBB	BBB+
Return on Debt %	5.39	5.39	5.39	5.39	5.67%	TBA
WACC %	7.19	7.20	7.20	7.18	7.38%	6.24^A

^A For comparison purposes Assumes cost of debt of 5.67%

The key difference in rates of return between the DNSPs and the AER is largely driven by the respective approaches to determine the MRP, equity beta and the transition to the trailing average cost of debt.

We note the amount of effort, resources and costs that the businesses have devoted in highlighting why the AER approach is wrong which appears disproportionate to the level of effort and arguments demonstrating why their methods are in the long term best interests of consumers.

3.3 Equity Beta

3.3.1 Foundation Model

The development of the AER's Rate of Return Guidelines has been subject to robust and extensive consultation and review. This Guideline sets out the methodologies the AER uses in determining a return on equity and a return on debt for in its regulatory determinations.

The NER requires that the return on equity for a regulatory control period must be estimated such that it contributes to the achievement of the allowed rate of return objective. The allowed rate of return objective means the rate of return for a DNSP is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the DNSP in respect of the provision of standard control services. In estimating the return on equity, regard must be had to the prevailing conditions in the market for equity funds.

The Victorian DNSPs have proposed a method where they have taken the weighted average of a number of capital asset pricing models. This compares to the AER's foundation model approach.

In its Guidelines, the AER stated that it does not use alternative models to provide different and distinct estimates of the return on equity for the benchmark efficient entity. The AER's position is that it is not satisfied that combining multiple return on equity estimates (the multi-model approach) would contribute to the achievement of the allowed rate of return objective.

In the Guideline development process, the AER explored the options of adopting a primary model, a primary model with reasonableness checks, several primary models with fixed weights or a multi-model approach.

The AER adopted the position that it must have regard to all relevant material submitted, including outcomes from the asset pricing models applied by the Victorian DNSPs (the SLCAPM, Black CAPM, FFM and DGM). When having regard to relevant evidence, the AER has undertaken to apply its judgement to determine how it can best incorporate this evidence into its return on equity estimate.

In decisions made to date, the AER has relied principally on the output of the SLCAPM. Origin has supported this approach in the past. We maintain our view that the AER has no reason to expect that adjusting the method it has adopted to date would better contribute to the achievement of the allowed rate of return objective.

3.3.2 Equity Beta

The Victorian DNSPs argue that it is not possible to understand how the AER has arrived at a figure of 0.7 for the purposes of the equity beta.⁸ The businesses go on to argue that the AER relies on a small set of partly dated data for domestic firms which is rapidly dwindling while unnecessarily discounting the effectiveness of international comparators.

They argue the modelling of the equity beta is flawed in that the sample is too small and the estimate too variable in response to the choice of statistical method. They submit that the most appropriate estimate for the equity beta ranges between 0.82 and 0.89 (subject to the individual weightings).

Origin recognises that as part of its decision making process for NSW the AER did not accept the equity beta of 0.82 proposed by the NSW DNSPs and instead adopted an alternative equity beta point estimate of 0.7.

We agreed with the AER position at the time that the intrinsic risk for the benchmark efficient entity would be very low because the DNSPs are insulated from the business cycle largely as a result of a regulatory regime where the businesses are not exposed to volume risk and have a guaranteed revenue stream under the revenue cap arrangements.

Notwithstanding the criticism tabled by the Victorian businesses regarding the AER's approach, we strongly support the relevancy of the data used by the AER. Specifically, we consider the use of data for domestic businesses to be reasonable comparators to the benchmark efficient entity.

The AER's consultants (McKenzie and Partington) noted that given the low default risk in regulated energy network businesses, the financial risk effects are 'unlikely to be substantive in normal market conditions'. McKenzie and Partington concluded:⁹

...it is hard to think of an industry that is more insulated from the business cycle due to inelastic demand and a fixed component to their pricing structure. In this case, one would expect the beta to be among the lowest possible and this conclusion would apply equally irrespective as to whether the benchmark firm is a regulated energy network or a regulated gas transmission pipeline.

⁸ Powercor, Regulatory Proposal, p. 216

⁹ AER Draft Decision, Attachment 3: Rate of Return, p. 236.

Specifically, the current regulatory regime includes an unders and overs mechanism that entitles the businesses to the full recovery of its revenue allowance in the event that there has been an under-recovery in any given year. Not only is the business entitled to this shortfall, but it is entitled to an indexation of any shortfall at the prevailing WACC until it is recovered in full.

Origin considers that a business that knows in advance what its revenue will be and to have that revenue guaranteed faces very little risk when compared to an energy business, such as Origin, which operates in an environment where there is actual competition and real market and operating risk.

For these reasons, Origin supports the AER's approach to determine systematic risk based on empirical studies of Australian energy network firms. Origin also agrees that international comparators should not be used as primary determinants of risk to the extent that the risks faced by these firms are not directly comparable to low risk regulated Australian businesses.

Given the risks faced by regulated business in practice, we consider that the AER has adopted a balanced and pragmatic decision to adopt 0.7 on the basis it is a modest step down from previous regulatory determinations. It provides a certain and predictable outcome for investors and a balance between the views of consumer groups and the businesses.

3.4 Return on Debt

The Victorian DNSPs accept that a trailing average portfolio approach is likely to more closely align with the staggered approach to refinancing a debt portfolio than the 'on the day' method.

However, the businesses disagree with the AER preferred transition method. The DNSPs consider that there should be:

- a ten year transition to the trailing average estimation of the risk free rate component of the return on debt; but
- no transition for the debt margin (or debt risk premium) component of the return on debt. That is the AER should immediately move to a trailing average estimation of the debt risk premium component.

As part of its rule determination relating to the economic regulation of network service providers (ERC0134), the Australian Energy Market Commission (AEMC) did not mandate any particular approach to estimating the return on debt. Instead, the final rule sets out at a very broad level the characteristics of three approaches to estimating the return on debt that could reasonably be contemplated by a regulator. The three options are designed to reflect an approach to return on debt based on.¹⁰

- the prevailing cost of funds approach;
- an historical trailing average approach; or
- some combination of these two approaches.

Furthermore, the AEMC intended the regulator to have the discretion to propose an approach and that this judgement is to be exercised in such a way as to be consistent with the overall allowed rate of return objective.¹¹

While the AEMC delegated discretion to the AER in terms of the approach and application of a calculation of cost of debt, it nevertheless considered the issue of transitioning. Specifically, the

¹⁰ AEMC, Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule, 2012, p. 90.

¹¹ AEMC, Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule, 2012, p. 90.

AEMC engaged SFG Consulting (SFG) to provide advice on a range of matters associated with the regulatory rate of return. SFG concluded that the type of “rolling in” arrangement that has been proposed by QTC would be an effective means of transitioning from the current Rules to the use of an historical average cost of debt approach.¹²

SFG also noted that if the regulatory allowance was set by not allowing an appropriate transition arrangement, the result would be either a potentially material benefit or loss to the business – and conversely a potentially material loss or benefit for customers. Moreover, an appropriate transition arrangement effectively destroys any incentive or ability for a business to seek to “game” the regulatory allowance by proposing whichever method might result in the highest allowance.¹³

In terms of addressing the issues of transitioning, AEMC stated that any transitional adjustment required should seek to achieve a neutral financial impact on the affected service provider and consumers.¹⁴

As required under the AEMC’s rule determination, the AER developed Rate of Return Guidelines. The development of the Rate of Return Guidelines provided a forum for the merits of different approaches to be examined and rigorously debated by all stakeholders. Origin considers that following consideration of the material presented through this process, the AER has exercised its judgement to arrive at a method to estimate the cost of debt consistent with the AEMC’s policy intent.

In terms of assessing the DNSPs proposed approach, we consider it necessary for the AER to explain to stakeholders the incentives that exist for the DNSPs in pursuing immediate application of the debt risk premium to the trailing average approach. For example, we would be concerned if the proposed approach would deliver a debt risk premium rise (for example, arising from the GFC which temporarily boosted the allowed revenues of the business relative to the costs actually incurred).

¹² SFG Consulting, Rule change proposals relating to the debt component of the regulated rate of return, Report for AEMC, 21 August 2012, p. 46.

¹³ SFG Consulting, Rule change proposals relating to the debt component of the regulated rate of return, Report for AEMC, 21 August 2012, p. 7.

¹⁴ AEMC, Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule, 2012, p.68.