6 January 2016

Mr Chris Pattas
General Manager – Network Investment and Pricing
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3000

Dear Mr Pattas

RE: SUBMISSION TO AER PRELIMINARY DECISION VICTORIAN NETWORKS

Origin Energy (Origin) appreciates the opportunity to provide input to the Australian Energy Regulator's (AER) assessment of the regulatory revenue proposals submitted by the Victorian distribution networks to determine their annual revenue allowances for the period 2016-20.

Origin agrees in principle with the approach taken by the AER to establish efficient costs with respect to operating and capital expenditure using benchmarking techniques as provided for under the National Electricity Rules (NER). The AER's approach has delivered significant but appropriate revenue reductions in its preliminary decision which will deliver savings for Victorian consumers.

Origin's responses to specific issues identified in the AER's preliminary decision are set out below.

Operating Costs

The AER states that under the NER, it is required to form a view about whether it is satisfied a service provider's proposed total opex forecast reasonably reflects the opex criteria. In making this assessment the AER develops an alternative forecast at the total opex level along with an assessment of the component parts that form the total opex.

In recent decisions for NSW and Queensland network businesses, the AER did not adjust base opex relative to the efficiency frontier. Instead it used a benchmark comparison point of the lowest of the efficiency scores in the top quartile of possible scores. This is equivalent to the efficiency score for the business at the bottom of the upper third (top 33 per cent) of companies in the benchmark sample. Origin did not agree with this decision to apply this lesser efficiency benchmark. We are concerned that the application of this lesser efficiency benchmark could create an incentive for businesses that are more efficient than the bottom of the upper third to increase the allocation of costs to opex to exploit this gap.

We believe the AER has partially addressed this incentive by not considering the inclusion of operating environment factors specific to individual Victorian businesses.

However, Origin notes that Citipower and Powercor have proposed to re-allocate corporate overheads that had previously been allocated to capital to now allocate these to opex. In response, the AER approved an average of capitalised corporate overheads from 2012-14. While this approach partially captures factors not influenced in any one year in the base opex, the AER has accepted the inclusion of $17.7M of overheads in opex for Citpower and $32M for Powercor.

Our concern is that these businesses may have allocated these costs to opex in knowledge that their opex is relatively more efficient than their capex and within the AER's revised benchmark. As a result, overhead costs that may not have been deemed efficient if they had been allocated to capex have now been included in allowed revenues. We are also concerned that to the extent that the base opex of the Victorian businesses are within the lesser efficiency frontier this may create an incentive for the businesses to revise their Cost Allocation Methods (CAM) to take advantage of this shortfall. We believe this incentive would not exist if a true efficiency frontier were applied.

Origin Energy Electricity Limited ABN 33 071 052 287 • Level 45, Australia Square, 264-278 George Street, Sydney NSW 2000
GPO Box 5376, Sydney NSW 2001 • Telephone 02 8345 5000 • Facsimile (02) 9252 9244 • www.originenergy.com.au

Furthermore, we are concerned that there appears to be a lack of consistency in the application of cost allocation. While we accept that the amount of costs allocated may change year on year we would be extremely concerned that businesses were allowed to amend their cost allocators year on year to achieve preferential regulatory outcomes.

For these reasons, we request the AER to re-consider its approval to allow an increased allocation of overheads to opex and to further examine the nature and timing of the allocation of overheads to capex and opex to ensure there are no unforseen consequences of the application of a lower opex efficiency benchmark.

Capital Costs

Each of the Victorian networks has proposed increases in capital expenditure relative to actual expenditure from the previous regulatory period. Origin maintains its support for the AER's approach to use a combination of top-down and bottom-up assessment techniques. We reiterate that 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.

In assessing the proposed capital expenditure we support the AER's use of the Australian Energy Marker Operator's (AEMO) 2014 connection point forecasts as a realistic expectation of demand over the 2016–20 period. We expect that the latest available data will be used as part of the AER's assessment for its final decision to ensure the most up to date data is used.

We also recognise that irrespective of aggregate demand forecasts that there will inevitably be pockets of demand growth that require augmentation. We support the AER's application of both technical assessments and the use of the augex and repex models to assess these projects.

With respect to non-network expenditure, we would expect that the profile of non-network costs would broadly align with direct network expenditure and therefore consider that similar reductions as applied to direct expenditure should also apply to non-network expenditure. However, we do recognise that IT system upgrades can be discrete and exhibit a different expenditure profile relative to direct network expenditure. Notwithstanding, we support the views of the Consumer Challenge Panel on IT system upgrades that ongoing IT capex should reflect a reduction from current levels in order to bring the amounts of capex back to 'reasonable' levels. In this regard, we support the AER's decision to impose reductions to the proposed ICT programs.

Similarly, we do not support the inclusion of expenditure associated with system upgrades associated with regulatory reporting obligations. We consider that information and financial data collection and reporting are a core activity of any business. We recognise that the businesses may have incurred some costs to enhance systems to map data from existing systems into the RIN format. However, do not expect these costs would be material as we anticipate that the majority of information sought by the AER would be captured as a matter of course and that the mapping into the AER format would not be onerous.

We agree that the AER's reductions in forecast expenditure should see a reduction in the size of both the total overheads and the level of capitalised overheads. The AER states that it has considered the relationship between opex and capex, specifically whether it is necessary to account for the way the CAM allocates overheads between capex and opex. The AER also states that opex assessment sets the efficient level of opex inclusive of overheads.

However, as we have stated above, we have concerns that unless allocators are appropriately assessed and fixed for a regulatory period, businesses may seek to be selective in allocating overheads between opex and capex, especially when there may be incentives (such as the AER application of a lesser opex efficiency benchmark) to allocate overheads to specific categories of expenditure.

Rate of Return

In our submission to the Victorian network's proposals and in response to the AER's assessment of other distribution businesses, we tabled our support for the AER's application of the Rate of Return Guidelines. Origin maintains its view that the AER has adopted a balanced and pragmatic approach that provides certain and predictable outcomes for investors and provides a balance between the views of consumer groups and the network businesses.

Specifically, we

- do not support immediate application of the debt risk premium to the trailing average approach;
- support the AER decision to adopt an equity point estimate of 0.7 on the basis it provides a certain and predictable and a balance between the views of consumer groups and the DNSPs; and
- support the AER decision to adopt a MRP of 6.50% as this better reflects the efficient financing costs of a business exposed to the level of risk that applies to an Australian regulated network businesses.

For further detail on our position on these points we refer the AER to our previous submissions.

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

Yours sincerely

Keith Robertson
Manager, Wholesale and Retail Regulatory Policy
(02) 9503 5674 keith.robertson@originenergy.com.au