origin

20 August 2014

Mr Warwick Anderson
General Manager - Networks Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Mr Anderson

RE: SUBMISSION TO ACTEWAGL'S REGULATORY PROPOSAL

Origin Energy Electricity Limited (ABN 33 071 052 287, "Origin") appreciates the opportunity to provide comments to the Australian Energy Regulator (AER) on the regulatory proposal submitted by ActewAGL under the National Electricity Rules (NER) for the regulatory period 2014-19.

Under ActewAGL's regulatory proposal, the average annual retail bill for both residential and commercial customers would increase more than the average increases recently proposed by Ausgrid, Essential Energy and Endeavour.

- For a residential customer, the ActewAGL proposal would increase their annual retail bill by an average of 3.1 per cent in each of the four years of the regulatory period compared to average increases of 2.2 per cent, 2.3 per cent and 1.4 per cent recently proposed by Ausgrid, Essential Energy and Endeavour, respectively.
- For a commercial customer, the ActewAGL proposal would increase their annual retail bill by 3.5 per cent on average each year compared to increases of 2.1 per cent, 2.3 per cent and 1.4 per cent proposed by Ausgrid, Essential Energy and Endeavour, respectively.

These price levels appear to be primarily driven by capex and opex levels that are being maintained at historical high levels and a return on equity of 10.71 per cent. In an environment where consumption and peak demand have been low and where consumption is forecast to remain soft, Origin questions whether these cost increases and high regulatory rates of return are consistent with the risks faced by ActewAGL and customer expectations around distribution service levels and their associated costs.

Presentation of Data

To support its regulatory proposals, ActewAGL is required to lodge completed regulatory information notices (RINs). Based on the documentation provided by ActewAGL to date, it has not been possible for Origin to compare summary expenditure with the sub categories in the RINs or reconcile this data with ActewAGL's regulatory proposal and its supporting arguments.

Origin considers that to promote constructive and informed stakeholder engagement, it is imperative that the data and information that underpins a regulatory review process is presented to stakeholders in a manner that is, to every extent practicable, transparent and comparable across each of the regulatory reporting documents and over time.

The AER has a key role in ensuring regulated businesses meet this requirement to produce meaningful, consistent and comparable data. Without this, it becomes extremely difficult for stakeholders to make informed and timely contributions to the regulatory review process.

Performance Standards

ActewAGL's requirements and obligations around distribution performance standards are set out in the:

- Distribution Network Augmentation Standard (the Standard). This Standard defines ActewAGL's security of supply criteria, from which it sets security standards by network element. The standard currently includes N-1 security criteria for transmission lines and zone substations and N criteria for distribution substations.
- Utilities (Electricity Distribution Supply Standards Code) Determination 2013 (the Code). The Code establishes minimum targets with respect to outage time (CAIDI), outage frequency (SAIFI) and outage duration (SAIDI) from which ActewAGL publishes annual targets for supply reliability.

The Code, however, also permits ActewAGL to set different service levels provided that they are advantageous to customers. For the 2014-19 reset period, ActewAGL appears to have set its reliability and security levels using information collected in customer willingness to pay (WTP) studies that considered the balance between cost and levels of service. ActewAGL believes this approach ensures that investment in its network reflect customers' preferred balance between cost and reliability.

Origin has not been able to access and therefore assess the appropriateness of ActewAGL's WTP studies. As a key input into setting security criteria and annual reliability targets, it is important these studies are reviewed, tested and verified to ensure they are robust, comprehensive and relevant. Security and reliability levels are both significant drivers behind DNSP investment and, therefore, cost. The AER needs to be confident that the consequential expenditure is justified.

Furthermore, Origin notes that ActewAGL has only recently formalised its consumer engagement strategy and that this will be rolled out after this regulatory proposal takes effect. On the basis that the most recent WTP study was conducted in 2011-12 and the customer engagement strategy has not been implemented, Origin questions how ActewAGL is reflecting the preferences of its customers in its proposed program of work.

By way of context, recent experience in New South Wales and Queensland shows that customers have expressed a preference that future improvements in reliability are not required, particularly at the expense of higher prices. Specifically, in July 2014, the NSW Government amended the licence conditions of distribution businesses to lower security of supply standards to be more in line with customer expectations.[1] Similarly in Queensland, the state Government also accepted a recommendation from an independent panel to reduce security standards and reliability levels.[2]

In light of the recent changes to security and reliability standards in Queensland and NSW, Origin would expect that similar customer preferences should also be evident in the ACT. This emphasises the need for scrutiny over ActewAGL's WTP studies.

Capital Expenditure

Origin would appreciate further clarification on what is driving ActewAGL's proposed capital expenditure for the 2014–19 regulatory period. The proposed expenditure levels appear to be marginally higher than actual capex levels from the 2009–14 regulatory period, which exceeded the AER's approved allowance by 18 per cent. Notably, asset renewal and replacement expenditure for the 2014–19 regulatory period is expected to be almost 50 per cent higher than in the 2009–14 period.

ActewAGL highlights that the key driver of its replacement capex is its ongoing pole replacement program. In addition, ActewAGL also intends to commence replacement of underground cables as assets reach the end of their useful life or where replacement becomes an economic alternative to reactive maintenance and replacement. In particular, the program will address an increase in underground cable faults incurred during the current period. Using an

[1] Reliability and Performance Licence Conditions for DNSPs, Anthony Roberts, Minister for Energy, 1 July 2014.
[2] Electricity Network Capital Program Review 2011.

enhanced web based software tool (Riva DS), ActewAGL can manage its assets and their replacement programs more efficiently than in the past, including individually optimised treatment plans and associated life cycle expenditure forecasts for each asset class.

The data from this enhanced system tool, however, indicate a slightly slower rate of asset ageing than analysis previously undertaken by ActewAGL had indicated. On this basis, Origin would expect that this would translate into a more stable or even lower replacement program. It is therefore difficult to reconcile the proposed increase of 50 per cent.

Origin encourages the AER to investigate the underlying risks and expenditure tradeoffs to ensure that customers are paying for a capex program that targets appropriate network security and demand outcomes, consistent with the capex objectives of the NER.

Operating Expenditure

Origin has a number of questions around ActewAGL proposal to keep operating expenditure for the 2014–19 regulatory period at similar levels to those in the 2009–14 regulatory period, despite the fact that there has been no observable efficiency gains from the previous regulatory period and a substantial increase in costs from $68 million in 2009-10 to $110 million in 2013-14.

First, Origin is unclear on what exactly is included in ActewAGL's opex proposal. At RIN Template 2.17, ActewAGL proposed a $22 million step change in opex costs. However, at Attachment B.10, the proposed step change is $35 million. Origin has been unable to reconcile the two sets of data.

Next, ActewAGL has proposed a 50 per cent increase in replacement capex. This is on the back of historically high capex levels from the 2009-14 regulatory period. Origin considers that the substantial capex program should deliver savings in reactive maintenance as ageing assets are replaced, reducing the incidence of asset failure. It seems inconsistent to have both an increased capex and opex program for the 2014-19 regulatory period.

Finally, Origin considers that many of the activities ActewAGL identifies as driving its step change in opex should already be embedded in its recurrent opex allowance. These include:

- devising, supporting the implementation of, and reporting on strategies that address changes in the regulatory and business operating environment;
- tracking business alignment with the regulatory submission;
- customer engagement;
- increased regulatory reporting to the AER and National Electricity Consumer Framework; and
- various regulatory projects such as formulation of an AER approved connection charge policy and charging manual, strategic review of network tariffs and a Legal Compliance Framework.

Origin considers that for a regulated business that has been subject to multiple regulatory reviews, the alignment of compliance, strategic and regulatory processes should be well entrenched in a comprehensive governance framework. Allowing ActewAGL to recover costs that should be part of its existing operational capability does not incentivise the business to achieve the efficiencies that both stakeholders and customers expect from the regulatory framework.

Weighted Average Cost of Capital (WACC)

ActewAGL states that if the AER uses its foundation model approach, this would rely on too narrow a use of material and, in current market circumstances, would under estimate the return on equity. ActewAGL cites a number of independent report it has commissioned supporting its position. ActewAGL proposes using an equity beta of 0.91 and a market risk premium of 7.21 per cent to generate a nominal vanilla WACC of 8.99 per cent, despite the fact that both of these variables significantly exceed the values that have been adopted by the AER and other regulatory agencies as accepted regulatory practice.

As Origin understands, the NER requires the AER to determine an allowed rate of return for a regulated network that is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of regulated services.

In terms of risk, Origin notes that under a revenue cap form of regulation, the revenue recovery is fixed and unrelated to energy sales. This guarantees a regulated business a predetermined revenue stream. In the event of an under or over recovery of revenue in any particular year, the unders and overs mechanism provides a time value of money adjustment for inclusion in the revenue allowance of future years. In addition, where there is an unforseen event that results in material costs to a regulated business, the regulatory framework provides for various cost pass-through provisions.

In terms of risk mitigation, these safety nets do not apply to any other firms operating in either the energy sector or other non-regulated markets. Therefore the degree of risk that applies to a regulated business must be substantially lower than the risk that applies to other firms.

For example, Macquarie Bank recently undertook analysis of market listed network businesses SP AusNet and Spark Infrastructure Group. In this analysis, Macquarie Bank applies an equity beta of 0.7 respectively, substantially lower than that proposed by ActewAGL.

On this basis, Origin does not agree that ActewAGL faces a degree of risk that is commensurate with an equity beta of 0.91 nor a return of equity of 10.71 per cent.

At a minimum, ActewAGL's equity beta should be set at 0.71 and its market risk premium at 6.5, which are consistent with the values adopted by the AER in its Transitional Distribution Decision for NSW and ACT.

Overheads and Balancing Item

ActewAGL's proposed capex overhead rate has increased dramatically compared to the last reset; over the last regulatory period the rate increased from between 2.3 per cent to 4.0 per cent whereas the rate for the 2014-19 period is set to peak at 15.6 per cent in 2015-2016.

Origin accepts that the rate for the 2014-19 regulatory period is more in line with industry norms. However, the volatility of the overhead rate raises questions about the robustness of the cost allocation process being applied by ActewAGL.

This is highlighted by the fact that in 2009, ActewAGL engaged external consultants to undertake a review of the validity and appropriateness of its corporate overhead allocation methodology. As a result of this work, there has been an increase in the direct allocation of corporate overheads to the electricity distribution business and this change in the corporate overheads allocation methodology came into effect from 1 July 2014.

Origin considers that it is imperative that the AER closely scrutinise the workings of the cost allocation methods of not only ActewAGL but all DNSPs to ensure that overhead costs are allocated on an appropriate and consistent basis over time to allow meaningful statistical comparison. Corporate and network overheads account for a significant amount of costs for a network business. It has historically been a cost that has been subject to inconsistency in its allocation.

In addition, Origin seeks clarification of the costs that are included in the "balancing item" for the 2014-19 regulatory period a these are of the order of 5 per cent of total proposed capex.

Non-network (Support Activities)

Support costs account for 33 per cent of ActewAGL's capex in 2014-15. This ratio reverts back to levels of the order of 15 per cent for the remaining years of the regulatory period. Relative to the NSW DNSPs, ActewAGL's ratios appear relatively high.

ActewAGL states that the largest component of non-network capital expenditure over the 2014–19 regulatory period is finance lease assets, which reflects the ongoing transfer of the Network Division's vehicle fleet to finance (capital) leases as existing operating leases expire.

Optimal fleet expenditure should be demonstrated through life cycle costing models that balance key inputs such as the quantum and composition of the program of work, fit for purpose vehicle selection, vehicle maintenance costs, replacement cycles and purchase versus lease options analysis.

ActewAGL has not populated RIN template 2.6 with fleet expenditure data. However, it appears to include capitalised lease expenditure in its post tax revenue model (PTRM). As a result, there is no reconciliation between the PTRM, the RIN and the regulatory proposal. Nor is the data sufficiently disaggregated to enable a stakeholder to make an informed opinion of the appropriateness of fleet expenditure.

For these reason, Origin considers that close scrutiny of Ausgrid's fleet costs are necessary and that data should be presented in a manner consistent with the RINs to allow direct peer comparison.

Maximum Demand

Origin understands that ActewAGL's demand is driven by a predominantly residential customer base, with strong winter peaks. Origin also notes that the rate of growth in winter peak demand has slowed since the early 1980s, largely as a result of substitution by gas for home and water heating. In addition, Origin notes there has been ongoing falls in consumption and slow growth in peak demand during the 2009-14 regulatory period.

ActewAGL is forecasting consumption to continue to fall over the first years of the 2014–19 period as a result of a weakening domestic economy. However, it forecasts a return to growth in peak demand in the 2014–15 year and continuing annual growth over the period.

Origin questions the strength of peak demand forecast by ActewAGL in light of the trend in consumption and demand from the 2009-14 regulatory period and the fact that forecast consumption is forecast to remain weak in the immediate term.

In addition, there should be clear explanation of the impact of any reduction in peak demand on capex.

Further information

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