13 February 2015

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

Dear Mr Anderson

RE: SUBMISSION TO AER DRAFT DETERMINATION FOR ACTEWAGL

Origin Energy Electricity Limited (ABN 33 071 052 287, "Origin") appreciates the opportunity to provide a response to the Australian Energy Regulator's (AER) Draft Decision with respect to the determination of regulatory revenue allowances for ActewAGL for the period 2014-15 to 2018-19.

The AER's decision is the first determination following changes to the National Electricity Law and National Electricity Rules in 2012. As a result, the AER has adopted a more holistic approach to decision making where it approves total expenditure allowances, not programs or projects. Under this approach, it is a matter for a distribution network service provider (DNSPs) to decide how and when it will spend its revenue allowance to run its network.

Origin agrees in principle with the approach taken by the AER to adopt a less prescriptive and granular approach to assess proposed costs and delegate greater responsibility to the businesses on how they manage their revenue allowances.

Despite a lessening of network performance standards and historically lower than expected system demand which are expected to remain moderate, the capital expenditure proposed by ActewAGL remains at relatively high levels. In addition, the AER found that ActewAGL adopted overly conservative criteria for the purposes of forecasting expenditure. This resulted in a failure to fully justify the timing and priority of its proposed forecast capital projects.

Origin is of the view that the onus must be on ActewAGL to demonstrate that any revised capital expenditure proposal is underpinned by prudent systems consistent with good operating practice and that these systems are using robust and reliable data. In the absence of a rigorous regulatory business case that provides stakeholders with confidence, Origin considers that the AER's alternative program better reflects the capex criteria set out in the National Electricity Rules.

In terms of operating costs, the AER's benchmark modelling revealed that ActewAGL appears to be the least productive distribution business in the National Electricity Market. On that basis, Origin considers that the AER has provided clear evidence for a downward adjustment to ActewAGL's base year opex.

In terms of the AER's approach to the weighted average cost of capital (WACC), we consider that the AER has applied its discretion to develop a transition to a trailing average cost of debt approach that is both consistent with the Australian Energy Market Commission's policy intent and the National Electricity Rules.

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

Finally, Origin supports the decision of the AER to establish upfront charges for new and upgraded meters from 1 July 2015, as well as its approach to remove exit fees. This is consistent with the objectives of the Australian Energy Market Commission's Power of Choice Review and will encourage competition and innovation in metering and related services. Origin also encourages the AER to ensure the annual metering charges for existing meters are set at a level that is compatible with supporting entry into the market for meter provision which will promote innovation and increase the range of services that could be offered to customers.

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

1. Capital Expenditure

Summary

- Origin considers that the onus must be on ActewAGL to demonstrate that proposed expenditure is underpinned by prudent systems consistent with good operating practice and that these systems use robust and reliable data. Where this is not demonstrated, Origin considers that the AER's alternative replacement and augmentation programs better reflect the NER expenditure criteria.

Background and AER's draft decision

ActewAGL proposed capital expenditure of $372.2M[1] ($2013-14). In response, the AER has approved an alternative allowance of $244.2M for the 2014-19 regulatory period.

The AER accepted the expenditure proposed by ActewAGL for customer connection and non-network capex but imposed reductions of $15.9M (14%) to repex, $37.8M (38%) to augmentation and $44.6M to network overheads (80%).

The AER found that ActewAGL's cost-benefit evaluation of each of its capital projects or programs reveals that its underlying risk assessment was overly conservative. As a result, ActewAGL failed to justify fully the timing and priority of its proposed forecast capex.

The AER also found that ActewAGL adopted overly conservative criteria when making augmentation decisions on zone substations. The AER considered that ActewAGL's distribution network augmentation standard did not incorporate changes made to the ACT Electricity Distribution Supply Standards Code (2013) to remove supply capacity requirements. In addition, the AER considered that ActewAGL's proposed value of customer reliability ($40.15 per kWh for the residential sector) was higher than the AEMO recently published value ($26.53 per kWh) for the ACT.

Origin's position

Origin recognises that utilisation of ActewAGL's network did not fall significantly in the 2009–2014 regulatory control period. However, in light of lower actual demand which is forecast to remain moderate at best or continue downwards, ActewAGL's network is under less pressure to meet the needs of additional customers or the increased demands of existing customers.

For this reason, we support the position of the AER that there is likely to be excess capacity in the network that could be utilised ahead of additional augmentation investment.

In Origin's submission to ActewAGL's regulatory proposal, we expressed concerns regarding how ActewAGL had integrated risk into its asset management framework as well as the proposed increases in network overheads. These issues were also identified by the AER.

On that basis, we consider that the onus must be on ActewAGL to demonstrate that any revised proposal is underpinned by prudent systems consistent with good operating practice and that these systems are using robust and reliable data. Where this is not demonstrated, Origin considers that based on the information presented, the AER's alternative program better reflects the capex criteria set out in the National Electricity Rules (NER).

[1] AER, Draft decision ActewAGL Distribution Determination, 2015-16 to 2018-19, Overview, p. 47.

2. Opex

Summary

- Origin supports the AER's application of the Expenditure Forecast Assessment Guideline to estimate an alternative base opex.
- Origin supports the AER's decision to accommodate general limitations of the benchmarking model.

Background and AER's draft decision

The AER imposed a 41.9% reduction to ActewAGL's proposed total forecast opex of $377M ($2013-14).[2]

The AER considered that inefficiencies were driven by ActewAGL's labour and workforce management practices, vegetation management practices and step change costs that relate to its current regulatory obligations.

The AER's assessment approach was consistent with its Expenditure Forecast Assessment Guideline. This approach involved comparing ActewAGL's total forecast opex with an alternative estimate developed by the AER that reasonably reflected the opex criteria. This alternative value used a combination of outputs from a number economic benchmarking models and adjustments to account for operating environment factors specific to the ACT. The AER then applied a number of category analysis measures to diagnose further areas of potential inefficiency.

To establish an alternative opex, the AER considered a cautious approach to benchmarking was appropriate to mitigate the potential risk of modelling and data error. In combination, the AER reduced the proposed base opex by 37% compared to the 60% reduction identified by its preferred benchmark model.

Origin's position

Origin considers that the AER has provided clear evidence for a downward adjustment to ActewAGL's base year opex. Benchmark modelling undertaken by the AER's consultant (Economic Insights) revealed that ActewAGL appears to be the least productive distribution business in the NEM.[3]

In adjusting the base opex, Origin agrees with the AER that a holistic approach is necessary, which balances the evidence from multiple lines of analysis. In this regard, Origin supports the AER's decision to recognise general limitations of the benchmarking model with respect to data imperfections and operating conditions specific to ActewAGL.

3. Transition to Efficient Opex

Summary

- Origin is strongly opposed to consumers having to continue to fund the inefficient costs of ActewAGL until it is able to transition to efficient levels. Any transition should be borne by the ActewAGL, not consumers.

Background and AER's draft decision

The AER is seeking views on whether it is appropriate to allow ActewAGL to transition from its current opex to what the AER has determined as efficient expenditure.

---

[2] AER, Draft decision ActewAGL Distribution Determination, 2015-16 to 2018-19, Attachment 7: Operating Expenditure, p. 7-7.

[3] AER, Electricity distribution network service providers annual benchmarking report, November 2014, p. 6.

Origin's position

Consumers have funded the current levels of opex, which were approved by the AER as part of its 2009 Determination. These costs are now considered materially inefficient. Origin is strongly opposed to consumers continuing to fund the inefficient costs of ActewAGL until it is able to transition to efficient levels.

To the extent ActewAGL has received excessive opex funding in the past, the onus of responsibility to restore network prices to efficient levels should reside with the business, not consumers.

4. WACC

Summary

- Origin considers that the AER has applied its discretion to develop a transition to a trailing average cost of debt approach that is both consistent with the Australian Energy Market Commission's policy intent and the National Electricity Rules.
- Origin considers there is insufficient evidence to support the assertion that a transition to a trailing cost of debt approach will not provide ActewAGL with an opportunity to recover at least efficient financing costs.

Background and AER's draft decision

The AER has approved a nominal weighted average cost of capital of 6.88%, compared to a rate of 8.99% proposed by ActewAGL.

In its Draft Decision, the AER did not accept the cost of equity proposed by ActewAGL and approved an alternative estimate of 8.1%. ActewAGL proposed a nominal post–tax return on equity of 10.71% derived from a multiple model approach. ActewAGL did not consider that that the AER's approach took account of all relevant information in calculating an appropriate cost of equity and that the application of the AER's foundation model is inconsistent with a market practitioner's approach.

ActewAGL proposed a return on debt estimate of 7.85%, based on an immediate transition to the 10 year trailing average approach as set out in the AER's Rate of Return Guidelines. The AER's draft decision is for a cost of debt of 6.07%.

Origin's position

ActewAGL acknowledged that the AER's trailing average approach is consistent with an efficient debt financing strategy. However, it did not accept that the previous on-the-day approach results in an efficient estimate of financing costs for the benchmark efficient entity. For this reason, ActewAGL argued that the pre-existing approach is of no relevance to the estimation of efficient financing costs in this regulatory period and its continuation would be perverse and hinder the achievement of the rate of return objective.

Consequently, ActewAGL proposed an immediate adoption of the AER's 10 year trailing average portfolio approach to the return on debt as it considers this is compliant with an allowed rate of return that achieves the rate of return objective.

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:[4]

- 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.[5]

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 AEMC engaged SFG Consulting (SFG) to provide advice on a range of matters associated with the regulatory rate of return. With respect to the issue of transitioning, SFG considered that if a material rule change is to be made, it is important to consider an appropriate set of transition arrangements. The lack of any transition arrangements in setting whether the rule change exposes regulated businesses to risks that they did not previously face is likely to be viewed by the market for funds as a signal that a higher degree of regulatory risk should be priced into their provision of funds. Such an outcome is unlikely to be consistent with the national electricity objective (NEO) and revenue and pricing principles (RPP).[6] SFG went on to state 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.[7]

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. [8]

In terms of addressing the issues of transitioning, the AEMC stated that any transitional adjustment required should seek to achieve a neutral financial impact on the affected service provider and consumers.[9]

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 what is permitted under the NER, Origin considers there is no impediment that prevents the adoption of a pre-existing approach as part of a transition, as argued by ActewAGL. The NER

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

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

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

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

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

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

provides that if the Guidelines indicate that there may be a change of regulatory approach in future distribution determinations, the Guidelines should also (if practicable) indicate how transitional issues are to be dealt with. We consider that the AER has fulfilled its obligations clearly in this regard.

In response to providing a neutral financial impact, we consider the timing of the switch to a trailing average approach is an important issue because the debt risk premium rise arising from the global financial crisis (GFC) temporarily boosted the allowed revenues of the business relative to the costs actually incurred. Therefore, there is an incentive for ActewAGL to switch to a trailing average regime so as to lock-in the accumulated GFC benefit before any reversal can take effect.

For these reasons, we consider there is insufficient evidence to support the assertion that a transition to a trailing cost of debt approach is inconsistent with the NER or that it will not provide ActewAGL with an opportunity to recover at least efficient financing costs and for these reasons consider that the AER estimate is consistent with the rate of return objectives of the NER.

5. Metering Services

Summary

- Origin supports the decision of the AER to remove meter exit fees thereby promoting competition in unregulated metering services.
- Origin supports the decision of the AER to establish upfront charges for new and upgraded meters from 1 July 2015 that is consistent with development of competition in the provision of new meters.
- Origin considers ActewAGL needs to provide annual metering charges for new and upgraded meters directly comparable to the new meter types being offered.
- Origin encourages the AER to approve labour and unit costs within an efficient range to ensure the annual metering charges for existing meters are compatible with encouraging entry into the market for meter provision.

Background and AER's draft decision

The AER considered that ActewAGL's metering proposal did not adequately prepare for competition in metering by only proposing one type of metering service.

The AER considered that there should be two categories of metering charges: (1) upfront capital charges; and (2) annual metering charges.

The AER considered that the upfront recovery of capital costs for new or upgraded connections as important in the context of the AEMC Rule change to expand competition in metering and related services. The AER therefore determined separate upfront charges using ActewAGL's material and non-material unit costs.

In addition, to promote competition, the AER classified residual metering costs as a standard control service and the recovery of these costs would be through network tariffs.

In determining metering unit costs, the AER accepted the advice of its consultant (Marsden Jacobs) that the maximum price of a single phase type 6 meter was $23.50 and a three phase type 6 meter as $100. However, unit prices proposed by ActewAGL were provided in confidence and not disclosed in the AER's decision.

Origin's position

Origin supports the decision of the AER to establish upfront charges for new and upgraded meters from 1 July 2015, as well as its approach to remove exit fees. We consider these decisions will promote competition in unregulated metering services which in turn will promote innovation and increase the range of associated services that can be offered to consumers.

However, another significant obstacle to effective competition is the transparent unbundling of metering charges from distribution use of system charges, especially for developing the annual meter charge for existing meters. This allows customers to compare the costs and benefits of different metering service options.

Origin considers that a charging structure that facilitates competition contains the following attributes:

- an annual metering charge for existing meters that recovers the residual capital costs of the existing meter as well as maintenance, reading and data services;
- an upfront charge for new and upgraded meters: and
- an annual metering charge for new and upgraded meters that recovers maintenance, reading and data services.

To assist in establishing the efficient annual metering charge, the AER requested its consultants (Marsden Jacob) to develop an efficient range of material unit forecasts as well as reviewing labour costs. Origin notes that Marsden Jacob used professional judgement to propose maximum rates for each meter hardware category.

In setting efficient prices, Origin encourages the AER to consider labour and unit costs within an efficient range to ensure the annual metering charges for existing meters are compatible with encouraging entry into the market for meter provision. Setting annual costs at a level below a new entrant's cost of service provision for an interval meter provides little incentive for a new entrant to enter the market and to allow customers to obtain advanced metering infrastructure from a range of competitive providers and therefore benefit from products and services that they could not otherwise access.

Furthermore, for the avoidance of doubt, Origin seeks confirmation of any non-capital charges that will be levied by ActewAGL on customers in the event that a customer switches from their existing meter to an unregulated meter provided by a third party meter provider.