



Supplementary Submission on the *Draft Decisions: Proposed Gas Access Arrangements NSW 2015- 2020*

27 March 2015

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Decisions: Proposed Gas Access Arrangements
*NSW 2015-2020***

Australian Energy Regulator

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Introduction

Ergon Energy Corporation Limited (Ergon Energy), in its capacity as a Distribution Network Service Provider (DNSP) in Queensland, welcomes the opportunity to provide this supplementary submission to the Australian Energy Regulator (AER) on its Draft Decision for the proposed access arrangement for the gas distribution network operated by Jemena Gas Networks (NSW) (Jemena) for 2015-2020.

Ergon Energy is interested in the determinations for NSW and the ACT DNSPs given the coincidence of timing with our own regulatory determination process and the indications from the AER that it is intending to apply similar assessment and benchmarking techniques to the Queensland DNSPs as occurred in NSW and the ACT. We therefore expect that in some areas the AER's analysis or basis for decisions in NSW and the ACT is likely to be similarly applied in, or relevant to, the decisions for Queensland and South Australia.

Additionally, the AER has considered the proposals put forward by the NSW and ACT NSPs based on a number of common expert reports. The positions put forward by the AER with respect to these common expert reports, in the absence of further consideration, are likely to impact our Preliminary Determination and contain various errors and flaws. Ergon Energy supports the use of robust benchmarking to provide insight for further assessment and understanding of performance across DNSPs, however, Ergon Energy urges the AER to exercise extreme caution in utilising its latest benchmarking report to effectively determine expenditure allowances.

Building on our submissions to the AER on 30 January and 13 February 2015, this supplementary submission focuses on providing some additional information on the following common areas:

- the Weighted Average Cost of Capital (WACC)
- benchmarking and the AER's decision framework in respect of forecast operating expenditure

Our submission has been prepared in the context of the AER's Draft Decision for the proposed access arrangements for Jemena, although many of the comments in this submission, as with those in our previous submissions, are relevant to other regulatory proposals currently under review by the AER, specifically:

- the regulatory proposal for the NSW and ACT electricity distribution networks operated by Ausgrid, Endeavour Energy, Essential Energy and ACTEW AGL
- the regulatory proposal for the NSW electricity transmission network operated by TransGrid
- the regulatory proposal for the South Australian and South East Queensland electricity distribution networks operated by SA Power Networks and Energex respectively.

This is especially so with respect to our submissions on the rate of return, where we anticipate that there will be a high degree of uniformity in the approach taken by the AER in making decisions for the different service providers currently under review. Consistent with the approach we took in the submissions made to the AER referred to above, we therefore request that the AER also take our comments in this submission into account when making its Preliminary Determination for Ergon Energy, as well as the other proposals identified above.

Ergon Energy is available to discuss this submission or provide further detail regarding the issues raised, should the AER require.

Weighted Average Cost of Capital

Ergon Energy notes the AER's Draft Decisions for the NSW and ACT NSPs in relation to WACC.

Like the NSW and ACT NSPs and other service providers identified above, Ergon Energy proposed a number of departures from the AER's Rate of Return Guideline (the Guideline) in our Regulatory Proposal (see Appendix C, Table 53). This is because we considered that certain aspects of the Guideline would not satisfy the requirements of the National Electricity Rules (NER) and the allowed rate of return objective.

We also relied on a number of expert reports to support the proposed rate of return in our Regulatory Proposal. Several of these were common expert reports and presented as evidence by the NSW and ACT DNSPs. We relied on the following:

- SFG Consulting: The required return on equity for regulated gas and electricity network businesses
- SFG Consulting: An appropriate regulatory estimate of gamma
- SFG Consulting: Cost of equity in the Black Capital Asset Pricing Model (CAPM)
- SFG Consulting: The Fama-French Model
- SFG Consulting: Alternative versions of the Dividend Discount Model and the implied cost of equity
- CEG: WACC estimates, A report for NSW DNSPs
- Kanangra: Credit ratings for regulated energy network services businesses.

We note the AER rejected many of the positions put forward by the NSW and ACT DNSPs and their experts. We assume the AER is likely to reach the same conclusions in our first determination.

Ergon Energy therefore jointly commissioned expert advice on the AER's Draft Decisions and supplied copies of these expert reports with its submissions to the AER on 13 February 2015. Since that time, Ergon Energy has received some further updates to a number of those reports and jointly commissioned a number of additional reports (refer to the table below). This advice is attached to our submission.

Firm	Report	Attachment number
SFG (Updated)	Overall Cost of Equity – 25/02/15	2.1
SFG (New)	Foundation Model	2.2
NERA (Updated)	MRP – 26/02/15	2.3
	Model Testing -26/02/15	2.4
NERA (New)	Tax Statistics	2.5
	Literature Review	2.6

We hope the AER will take these concerns into consideration in its final determination for Jemena, NSW and the ACT DNSPs and other service providers, as well as our own Preliminary Determination.

Benchmarking

Ergon Energy notes that Jemena commissioned Economics Insights (EI) to prepare a number of benchmarking reports in support of its proposed access arrangements for 2015-2020, focussed on the relative opex efficiency and forecast opex productivity growth of Jemena.

Ergon Energy notes that EI identified a number of exogenous influences affecting the cost efficiency of the gas networks analysed and which were largely beyond management control, including climate, geography, topography and demography of the NSP's service area.

The studies conducted by EI for Jemena included specific allowance for a number of key operating environment factors in order to seek to avoid producing an inaccurate and misleading estimate of the scope for opex productivity growth and of relative efficiency levels due to not undertaking like for like comparison.

The three key operating environment factors that were included in the EI study for Jemena were customer density, the proportion of cast iron/unprotected steel mains and service area dispersion.

In relation to the inclusion of the operating environment factor regarding the proportion of cast iron/unprotected steel mains, EI made the following observation at page 42 of their 25 February 2015 report to Jemena:

“The progressive replacement of cast iron/unprotected steel mains with new mains made with modern materials substitutes capital for non-capital inputs and is a source of reduction in maintenance costs over time. Failing to take into account this source of reduction in maintenance cost would confuse factor substitution with productivity change. It would place at a disadvantage those GDBs that have renewed their former cast iron/unprotected steel networks, and no longer have this as an ongoing source of reducing opex”

Whilst Ergon Energy has not conducted a detailed analysis of the EI reports produced for Jemena, it seems to Ergon Energy that the EI reports produced for Jemena suggest that the efficient cost of operating and maintaining a network depends on the capital assets employed in delivering electricity to end users.

This finding by EI is consistent with the analysis that Ergon Energy has provided in various other submissions to the AER, as well as in its 2015-2020 Regulatory proposal. For example, at page 7 in Attachment 10 to our 13 February 2015 submission to the AER, Synergies made the following observation:

“The impact of a DNSPs network, as reflected in the quantity of capital that it deploys, for its operating costs is apparent from the MTFP analysis undertaken by Economic Insights. Opex efficiency is strongly correlated with capital efficiency. This shows that operating costs and capital costs are likely to be complementary for distribution businesses; as a DNSP increases the number and length of transmission lines that it operates, it also increases the number of employees it needs to maintain and operate them. This has important implications for the interpretation of the controllability of operating costs. It indicates that operating costs inefficiency as determined by these benchmarking models is not wholly controllable. Rather, the nature of the capital stock limits the extent to which operating costs can be reduced.”

For the current management of network businesses the existing stock of assets are a legacy resulting from past decisions, and, in the short to medium term, management has very little

opportunity to modify the inherited network configuration. In economics, this is referred to as the putty-clay model of production, in which the *ex ante* production function (i.e. before a network design paradigm has been selected) allows for a wider range of substitution possibilities between input factors (labour, materials, energy etc) than the *ex post* production function that applies once a network has been built. In some industries studied, the impact of the vintage of the assets on production costs is very large, which is consistent with the observation that technical progress in production is frequently embodied in new equipment. For further discussion on this topic see, for example, Johansen, L. (1972), *Production Functions*, North-Holland and Førsund, F. and L. Hjalmarsson (1987), *Analyses of Industrial Structure: A Putty-Clay Approach*, The Institute for Economic and Social Research, Stockholm. The putty-clay approach has recently been extended to allow for more flexible substitution *ex-post* patterns; see Hochman et al (2010), “A Technological Response to Environmental Policy: From Putty-Clay to Putty-Doh”, University of California, Berkeley.

The above-mentioned analysis has implications both for the assessment of relative efficiency the AER may make under the applicable rules for various network businesses using its various benchmarking tools, as well as how the AER assesses whether a transition path for a particular network service provider may be warranted where the AER's expenditure forecast is lower than a service provider's forecast.