8 August 2018

Mr Sebastian Roberts
General Manager
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Email: NSW2019-24@aer.gov.au

Dear Mr Roberts

RE: REGULATORY PROPOSALS FOR NSW ELECTRICITY DISTRIBUTORS 2019-24

Origin Energy appreciates the opportunity to provide a submission to the Australian Energy Regulator's (AER) assessment of the regulatory revenue proposals submitted by the NSW electricity distribution businesses for the period 2019-24.

We appreciate the engagement of the businesses in explaining their revenue proposals, notably Essential Energy. While we have not agreed with all aspects of their proposals, it has been a valuable and productive process.

The NSW businesses have undergone significant transformation over the previous regulatory period and have delivered significant cost reductions. We recognise that the magnitude of these reductions are not sustainable. Nevertheless, we do expect the businesses to realise further productivity gains from investments in technology and from more mature and rigorous risk and asset management processes than operated previously.

In terms of the proposed Tariff Structure Statements, we support the move towards cost reflective pricing. However, for these reforms to be successful customers must be able to understand their tariffs so that they can optimise their benefits or at least minimise negative impacts. The necessary pre-conditions for this are broad-based customer education and sufficient penetration of demand response technology. We strongly believe these pre-conditions must be delivered before the mandatory assignment to complex tariffs. Otherwise, we are concerned that this would compromise the ability of these reforms to be successful.

Origin's responses to specific issues are set out below.

Cost of Capital

The NSW networks have adopted the AER's standard approach to the rate of return as set out in the AER's 2013 Rate of Return Guideline. The AER is required to complete a review of this guideline by December 2018.

The AER has recently released a draft decision on its revised guideline. Origin strongly supports the AER's draft decision and for these positions to be reflected in the cost of capital of the businesses.

Origin has previously argued that regulated networks face a very low business and financial risk environment and that the assessment of risk to be among the lowest possible. As part of the previous determination we argued for an equity beta at the lower end of the range of the AER's empirical analysis. We maintain this position and strongly support the AER's decision to apply an equity beta of 0.6 as part of its draft guideline.

In terms of the cost of debt, we also continue to support the AER's trailing average cost of debt approach. While we support the continued use of a BBB+ credit rating, we believe this generous given the very low businesses risk profiles of the networks.

Operating Expenditure

Origin recognises that each of the NSW networks have taken steps to transition to more sustainable levels of underlying opex through reductions in their respective workforces which resulted in substantial redundancy costs in the current regulatory period. We also accept that these are one-off reductions and should not be treated as an indication of future achievable productivity gains.

However, Ausgrid and Endeavour have both proposed no productivity cost gains for the next regulatory period arguing that future efficiencies are captured by escalating labour costs with the wage price index rather than EBA wage growth factors as well as absorbing costs that would otherwise be included as step changes. Also, they argue that given the significant cost reductions in the current regulatory period, no further productivity adjustments are appropriate.

Essential on the other hand has highlighted that as a result of investment in mobile technology, work scheduling and planning applications it will deliver productivity benefits that will offset the effect of output growth and input price changes over the regulatory period.

We recognise the transformational change each of the businesses have experienced over recent years and the challenges this presents in maintaining operational performance. However, as these businesses transition to more efficient structures we expect that this will also translate into the more effective and efficient delivery of services; internal and external.

Given the magnitude of the productivity gains proposed by Essential, it seems implausible that neither Ausgrid nor Endeavour could not also achieve productivity gains. For this reason, we believe that the AER ought to closely examine the ability of the networks to achieve productivity gains over the next regulatory period.

Furthermore, to the extent that the networks identify efficiency gains on cost estimates for activities sourced from an effectively competitive market and those transactions involve a related party, it is imperative that the AER closely examine these arrangements. While the regulated business may transact at arm's length with a related party, we believe such transactions do not carry the same rigour as procurement from a truly independent competitive process; instead, relying on the robustness of the cost allocation methods and ring-fencing. For this reason, the AER should apply particular attention to the efficiency of any related party transactions.

We also believe that where the networks have proposed demand side management initiatives, that these should be subject to a RiT-D to ensure that the projects are delivering optimal outcomes and that third party procurement has been appropriately considered.

With respect to debt raising coasts, we understand that this is determined as an annual allowance calculated as a percentage applied to the benchmark debt; i.e. 60 per cent of the value of the RAB. However, we understand that the trailing average portfolio approach assumes a portfolio of debt with staggered maturity dates. As a result, the AER assumes that the benchmark efficient entity issues debt uniformly over time in tranches of equal size. For this reason, we believe the debt raising cost allowance

should be calculated using the value of the annual debt tranches (i.e. 10%) instead of a network's total debt.

Capital Expenditure

As part of the previous determination process, the AER highlighted concerns around the governance of capex forecasting which resulted in replacement capital forecast being overstated. In particular, the AER highlighted that the networks' methodologies did not have sufficient regard to top-down efficiency tests or delivery strategies. The AER also raised concerns that the networks' risk assessments were overstating costs due to inadequate options analysis and a lack of justification of the timing for resolving the condition-based issues. For this reason, we strongly encourage the AER to re-assess these practices to ensure they have been properly addressed.

We note that the replacement capex continues to be the dominant cost component. The networks state that based on the combination of the existing value of the respective asset bases and the current weighted average asset lives, this will result in a steady replacement capex that would exceed current forecasts.

We do not believe applying a static analysis of the existing asset bases relevant. We believe that the nature of the distribution networks are evolving as smart meters and new technologies achieve greater penetration. This will have implications for the nature of how networks are operated and consequently the nature of future network expenditure. The AER ought to assess what assumptions the networks have made around the timing and impact of these scenarios in their predicative modelling to ensure, for example, replacement capex is not overstated.

We also note that the levels of non-system short aged assets proposed by Essential appear to be at persistently high relative values across multiple regulatory periods and, as a percent, consistently exceeds the spend of the other networks. While we recognise that the Essential network has vastly different characteristics to the other businesses, we do not believe this would drive continually high non-system costs and would expect the trajectory and proportion of these costs to be comparable across the three businesses.

Origin supports the use of distributed energy to provide network services and the benefit of centralised utility scale battery systems. These assets provide an effective mechanism to address network issues. However, it is unlikely that batteries will be used for extended durations of time to provide network support. Therefore, it is unlikely they would represent a least cost option if they were capitalised. This is because, networks are not permitted to realise the full value stream of a battery when this includes contestable energy services. For this reason, we would expect to see the costs of centralised utility scale battery systems expensed and these services sourced from third party providers rather than capitalised.

Tariff Structure Statements

Origin recognises the importance of reforming network tariffs. By sending clearer signals to consumers about the cost of supplying electricity, consumers will be better placed to make more efficient decisions about how much electricity they use and when to use it. This will remove cross-subsidies and result in more efficient future network expenditure.

Origin accepts that the core problem with the current flat rate network tariffs is that they lack cost-reflectivity. The use of a flat volumetric charge spread equally over all time periods provides no signal to consumers about the value of using electricity over peak demand periods when the cost of supply is high.

However, the challenge is that the reforms have competing objectives. For example, some tariff structures may deliver high levels of economic efficiency but are too complex for consumers to understand and therefore respond to; difficult for retailers to implement; or have adverse impacts on

particular cohorts. While improving cost-reflectivity is a key objective, it is not the only principle relevant to tariff design. As set out in the NER, tariffs must also be reasonably capable of being understood by retail customers.

In this context, we believe it is necessary to recognise that network revenues and prices are currently moderating. This is in large part due to a lower weighted average cost of capital, diminishing costs of solar PV subsidies recovered through network charges (in Queensland and NSW) and greater regulatory scrutiny of costs. As a result, we believe this presents an opportunity to re-ask the question "how best to transition" to cost reflectivity to provide the reforms with the best possible chance of success.

A prerequisite for being able to charge cost reflective network tariffs is metering that can record usage by a customer at different times of the day. As such, cost reflective network tariffs can only be applied to those customers who have a smart or interval meter installed. Furthermore, effective smart demand response technology that enables greater energy management is not yet sufficiently available or economical for the vast majority of residential customers. Origin is actively exploring options in this field and would be happy to step the AER through how we see technology progressing in the short and medium terms.

Therefore, in the absence of a material penetration of appropriate technology in the correct network locations, the effectiveness of cost reflective tariffs will be muted. Under these conditions it is not clear that a broad-based cost reflective network tariff is the most effective immediate mechanism to address constraints that are confined to pockets of the network. Therefore, we believe incentive based demand management initiatives may provide a more effective outcome in the short-term.

With regard to the proposed tariffs, each of the NSW businesses have put forward different tariff structures and different assignment policies. We believe this lack of consistency is unhelpful and challenging for retailers to implement. Not only does this create complexity, it also increases the costs to retailers of building multiple tariff structures into billing systems. In addition, customer tools such as price comparators become increasingly complex, especially when both customers and retailers have no line of sight of historic usage when a customer is transitioning from an accumulation meter to a smart meter.

In such circumstances, the customer will find it difficult to obtain an accurate comparison of offers, or worse, the absence of an historic load profile produces inaccurate comparisons. Either way, such an outcome would be detrimental to introducing cost reflective tariffs.

We believe the proposed tariffs do not satisfactorily meet the criteria of simplicity. For example, under the Endeavour Transitional TOU tariff, the customer will be exposed to four different charging components with potentially four network price changes throughout a year. In the case of Ausgrid, the customer will be exposed to nine charging components with potentially four network price changes. In the case of Essential, customers installing new technologies will be exposed to a kVA charge; a complex charge that the vast majority of residential customers will not understand in the event a retailer were to pass this signal through unfiltered.

Many customers already struggle understanding their electricity bill. This is going to increase in the event that they are exposed to more charging parameters and constant price changes. We do not believe the networks have struck the correct balance between simplicity and cost reflectivity for a mandatory tariff at this stage of the reform process. As a result, the retailer can either expose customers to these signals or, more likely, moderate the signal and price the financial risk of a mismatch in retail tariffs. Either option being sub-optimal for consumers.

For the reasons stated, we believe that the more effective and pragmatic strategy at this stage is twofold. First, there needs to be better education of customers before exposing them to tariffs they are unfamiliar

with or are complex. We recognise and appreciate the work that the NSW networks have done to date in terms of explaining their tariffs to retailers and consumer groups. However, education must be consistent, simple, and broad-based; a responsibility beyond the scope of networks and retailers in isolation. In this regard, we agree with the views raised by the ACCC that there may be the need for government communication campaigns in conjunction with retailers and networks to provide consumers with information about the benefits of cost-reflective pricing and to explain to customers how they can manage the potential impacts of these reforms.

This coordinated approach to education is a necessary pre-condition for tariff reform to be successful. While the AER may consider such a decision to allocate this responsibility outside it's dominion, we strongly encourage the AER to consider this option and how best it could be achieved.

Second, given that network charges have moderated and there is low availability of smart demand response technology, there does not appear to be the urgency to proceed as far down the cost reflectivity spectrum as the NSW tariffs have proposed. We believe greater long-term reform success will be achieved with an initial conceptual understanding of cost reflectivity. For this reason, we advocate simpler tariffs until such time that a broad-based education program is shown to be effective. This approach should be complemented with retailers also undertaking more trials and offering opt-in tariffs to observe and understand how tariffs work in practice with engaged participants.

In an industry subject to ongoing external reviews, reforms, and technological change, we believe this two-staged approach provides a measured and sensible path to enable customers to optimise their energy usage at a pace that does not compromise the policy intent. It recognises that moving away from flat network tariffs will create winners and losers and this needs to be managed through a coordinated education model. This will provide consumers with the knowledge and opportunity to adapt and alter their behaviour. This means enabling winning customers to optimise their benefits while enabling losing customers to become beneficiaries or at least minimise negative impacts.

Closing

Origin recognises the progress that both the businesses and the AER have made to transition towards more sustainable network costs and revenues. Nevertheless, we believe that there is opportunity to realise further productivity gains in both opex and capex through improved planning and technology gains.

While we support the tariff reform process, we maintain our concerns that the necessary pre-conditions have not been met and suggest that a more measure implementation approach is required to ensure the success of the reforms.

We look forward to further engagement with the AER and the businesses throughout this assessment process.

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

Yours sincerely

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