10 August 2015

Warwick Anderson
General Manager – Network Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Submitted by email: AGN2015AAR@aer.gov.au

Dear Mr Anderson

AUSTRALIAN GAS NETWORKS 2016-21 ACCESS ARRANGEMENT PROPOSAL FOR ITS SOUTH AUSTRALIA GAS DISTRIBUTION NETWORK

Origin Energy LPG (Origin) appreciates the opportunity to provide a response to Australian Gas Networks' (AGN's) proposal in relation to the Access Arrangement (AA) for its South Australia gas distribution network for the 2016-2021 period.

Origin acknowledges the proactive approach taken by AGN to engage with retailers in the lead up to this AA. AGN regularly met with retailers throughout the development of its proposal and notably, provided an opportunity to review and provide feedback on its proposed terms and conditions. AGN has also continued to engage with retailers following the lodgement of its proposal. We very much appreciate these efforts and would like to see a similarly consultative process undertaken for all networks going forward.

A network's AA is an important factor in a retailer's ability to deliver quality gas services to customers. AGN's AA therefore needs to support effective operations and set a reasonable revenue allowance and efficient service fees as shortcomings in these areas can impede a retailer's operations and increase customer costs. While AGN has proposed a forecast revenue allowance that provides an upfront price cut on 1 July 2016, Origin considers there are additional efficiencies that could further improve customer outcomes. As such, this submission focuses on those areas where we see potential for further enhancements or where we consider AGN's proposal has not been clearly explained or justified.

Should you have any questions on this submission, please contact Lillian Patterson in the first instance on (02) 9503 5375 or lillian.patterson@originenergy.com.au.

Yours sincerely

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

Origin Energy LPG limited ABN 77 000 508 369 • Level 45, Australia Square, 264-278 George St, Sydney NSW 2000
GPO Box 5376, Sydney NSW 2001 • Telephone (02) 8345 5000 • Facsimile (02) 9252 9244 • www.originenergy.com.au

Response to Australian Gas Networks' Proposal for the 2016-2021 Regulatory Control Period for its South Australia Gas Distribution Network

Origin Submission

August 2015

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1 Revenue Components

In its proposed Access Arrangement (AA), Australian Gas Networks (AGN) proposes to reduce distribution tariffs by eleven per cent in real terms on 1 July 2016, followed by tariff increases of five per cent in real terms in each remaining year of the next AA period.[1] This is required to support:

- investment of $353 million in operating expenditure and $699 million in capital expenditure (capex) over the next AA period from 2016-21, which is around 29 per cent higher than the expenditure expected to be incurred over the current AA period;[2] and
- a 7.23 per cent rate of return, comprising a return on equity of 9.91 per cent and a return on debt of 5.44 per cent.[3]

Origin's below comments on the revenue components of the AA generally relate to those issues where AGN's proposal has not been clearly explained or justified and therefore we would appreciate the Australian Energy Regulator (AER) paying particular attention to these issues in its assessment.

1.1 Capital Expenditure for Information Technology

AGN's proposal discusses its program of work to replace old state-based information technology (IT) systems that have been in place for over ten years with a new national IT program servicing all five jurisdictions in which AGN operates. It forecasts IT capex of $59.7 million, which equates to around 10 per cent of total forecast capex over the next AA period.[4]

Given the national nature of this IT program, its benefits and costs extend beyond AGN's South Australia (SA) network to its other fully regulated networks in Victoria and Albury, as well as its light regulated and unregulated networks. As a result, Origin asks that the AER carefully review AGN's proposed capex to ensure that the proposed costs are isolated solely to the SA network based on the principle that costs should be allocated on a user basis. It would not be efficient for the full costs of the IT program to be recovered through this AA and hence paid for by SA customers only. The costs should be appropriately apportioned to each of the networks in order that SA customers only pay for the costs associated with their network. No network should have to pay a disproportionate amount of the costs for a national program nor should AGN be able to double dip by seeking to recover costs allocated to this AA in its existing AAs or future AA proposals for its other networks.

1.2 Indexation applied to the Regulated Asset Base

AGN's proposal discusses two scenarios—cash flow derived from its AA proposal and cash flow derived from its AA proposal adjusted for the most recent AER decision on the regulation rate of return of 5.45 per cent for SA Power Networks—to assess whether the required credit metrics are maintained if the rate of return is varied. It finds that the required credit metrics for a BBB+ rated business are "(just) met" for its revised AA proposal but are not met if the AER were to substitute a lower rate of return. As a result, it finds that applying a lower rate of return without also applying measures to improve financeability would be inconsistent with the National Gas Law and National Gas Rules (NGR). To counter this, AGN suggests the AER could increase the cash flow to the business by varying the level of indexation that is applied to the regulated asset base, which would have the effect of changing the depreciation profile (and hence cash flow) of the business. It has not, however, varied the level of the indexation on the basis that its AA proposal allows the business to maintain a

[1] AGN, *Proposed 2016-21 Access Arrangement Information*, July 2015, pp. 10-1.
[2] Ibid, p. 8.
[3] Ibid, p. 10.
[4] Ibid, pp. 137-41.

BBB+ credit rating.[5] Presumably, this discussion in intended to indicate that should the AER approve a lower rate of return, AGN would have to reassess its proposed level of indexation.

The intention of the AA is to set the benchmark revenue needed to cover efficient costs and provide a commercial return on capital for the provision of the reference service on the gas network. This ensures that customers only pay efficient costs for the network. It is not the role of this regulatory framework to provide additional benefits or compensation to a network business should it consider it is unable to operate within the efficient benchmark set for it. A network business makes its own choice on whether it operates within the benchmark and as a consequence, it may outperform or underperform the benchmark but this is a decision for the business not the regulator. Given this, Origin does not consider it appropriate that the level of indexation be varied to allow AGN a changed depreciation and cash flow profile should the AER decide on a lower rate of return.

1.3 Rate of Return

AGN has proposed a rate of return of 7.23 per cent. This is higher than the 7.15 per cent rate of return proposed by ActewAGL Distribution for its gas network and 5.41 per cent rate of return recently approved by the AER for Jemena Gas Networks (JGN).[6] While AGN agrees with many of the factors for estimating the rate of return set out in the AER's Rate of Return Guideline (Guideline), it departs from the Guideline in relation to the following issues:

- Return on equity – AGN uses a multi-model approach to determine return on equity (in place of the Guideline and the AER's recent decisions, which place sole reliance on the Sharpe-Lintner capital asset pricing model); AGN uses a range of domestic and foreign data to produce an equity beta estimate of 0.82 (compared with the AER's position to rely primarily on domestic data to arrive at an estimate of 0.7); and AGN gives a market risk premium estimate of 8.23 per cent based on a wider range of evidence and after applying a weighting based on the strengths and weaknesses of this evidence (whereas the AER relies primarily on historical excess returns to arrive at its estimate of 6.5 per cent).[7]
- Return on debt – AGN proposes a hybrid approach to transition to the new ten-year trailing average of the cost of debt on the basis that this is more consistent with the debt financing practices of a benchmark efficient business given no transition is used for the debt risk premium component because businesses such as AGN already have a trailing average debt risk premium (compared with the AER's ten-year transition approach).[8]

In Origin's view, the Guideline provides certainty and predictability of outcomes in rate of return issues and a balance between the views of distributors and consumers. A departure from the Guideline should only be approved where there is strong evidence to support the departure. Each of the departures proposed by AGN has already been proposed by other networks through their AA processes, assessed by the AER and not accepted.[9] The AER has considered its approach to these elements produces a rate of return that best reflects the rate of return of a benchmark efficient entity.

In its proposal, AGN has repeated many of the arguments used by other networks with little additional evidence to support its position. We do not consider AGN has provided any new compelling arguments to suggest reopening the elements that the AER has already considered and not approved for other networks. Maintaining the rate of return approach in the Guideline and applied to other

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[5] Ibid, pp. 162-5.
[6] ActewAGL Distribution, *Proposed 2016-21 Access Arrangement Information*, June 2015, p. 37; AER, *Final Decision on 2015-2020 JGN Access Arrangement*, June 2015, p.11.
[7] AGN, *Proposed 2016-21 Access Arrangement Information*, July 2015, pp. 173-4.
[8] Ibid, p. 174.
[9] Examples include the 2014-19/2015-20 Access Arrangements approved by the AER for JGN, Ausgrid, Endeavour Energy and Essential Energy.

networks ensures that the final approved rate of return for AGN is consistent with the rates of return across all networks.

1.4 Incentive Arrangements

Efficiency Benefit Sharing Scheme and Capital Expenditure Sharing Scheme

Origin supports efficiency incentives in principle as providing incentives for networks to reduce spending to efficient levels and rewards customers where this occurs. To the extent an Efficiency Benefit Sharing Scheme (EBSS) and Capital Expenditure Sharing Scheme (CESS) can deliver these incentives and as a result, long term benefits to customers, Origin supports the retention of the EBSS and introduction of the CESS. We caution, however, that these schemes must be carefully calibrated with the rest of the regulatory framework to avoid creating perverse incentives, specifically through non-consistent cost allocation over time.

Customer Service Incentive Scheme

AGN's stakeholder engagement indicated 65 per cent of workshop attendees were prepared to pay up to $0.50 per year more to implement a Guaranteed Service Level (GSL) scheme, which would provide compensation to those customers that receive service below an 'agreed' level. AGN has responded that there are practical limitations to introducing a GSL scheme at the start of the next AA period that make it infeasible. It does, however, intend to undertake further consultation in 2016 with a view to introducing a customer service incentive scheme on 1 July 2017.[10]

Origin supports the introduction of a customer service incentive scheme. Not only has this seen general support directly from AGN's customers but it will also assist retailers to deliver a higher level of service to our customers. We ask that the AER review AGN's reasons for why this scheme cannot be introduced before 1 July 2017 as it would be in customers' best interests that the scheme starts as soon as possible. We also look forward to engaging with AGN on the development of the scheme to ensure it best reflects value to customers.

1.5 Reference Tariffs

Origin supports AGN's proposal to maintain the same tariff structures that apply in the current AA period for the majority of its tariffs. We also support the minor amendment to regional Tariff D structures to align them with metropolitan Adelaide Tariff D classes.

Origin supports AGN's proposal to continue with the structure and rate (in real terms) as in the current AA for its ancillary reference services and include three new ancillary services for meter removal, meter reinstallation and meter gas and installation test. Through AGN's Retailer Reference Group, Origin requested these three ancillary services to align the SA AA with AGN's other networks. We thank AGN for accepting our request.

1.6 Tariff Variation Mechanism

AGN's proposed tariff variation mechanism and process are broadly consistent with its current AA. The only proposed change relates to the date by which AGN must submit its annual tariff variation mechanism proposal to the AER. It proposes that it will notify the AER in respect of any variations at least 40 business days before the tariffs are proposed to come into effect. Currently, this requirement is 50 business days. This would effectively provide the AER with 20 business days to review and

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[10] AGN, *Proposed 2016-21 Access Arrangement Information*, July 2015, pp. 200-1.

approve or reject the proposed variations and then allow market participants 20 business days to prepare for the implementation of the new tariffs.[11]

For a tariff variation in the first year after the commencement of the AA, which would be on 1 July 2017, AGN would have to lodge its tariff variation mechanism proposal before 8 May 2017 under its proposed 40 business day timeframe. We note that in JGN's recently approved 2015-20 AA it is required to lodge its tariff variation proposal with the AER on or before 15 March 2017 or the next closest business day.[12] It is unclear why there are differing treatments of tariff variations for the two networks although they have the same effective date. In particular, it is unclear why AGN is proposing to reduce the number of business days before the effective date that it must lodge its proposal while JGN is required to lodge its proposal almost two months prior to AGN. In its considerations, we would appreciate the AER taking into account that retailers require approximately six weeks to incorporate any network tariff changes into our systems and give adequate notice to stakeholders.

1.7 Cost Pass Through Events

AGN notes its proposed cost pass through events are generally consistent with those applied in the current AA period but with one amended event and two additional events. As a principle, Origin prefers that AAs are as consistent as possible across networks. As such, we broadly support AGN's proposed cost pass through events where they are generally aligned with those already approved in other AAs, such as the 2013-17 Envestra (Victoria) AA and 2015-20 JGN AA. However, we caution that continual extensions to the range of cost pass through events potentially undermine customer price certainty and therefore should be limited as much as possible. Cost pass through events should also not be approved for matters that could reasonably be considered as standard business for the network.

Network User Failure Event

In the recently approved 2015-20 JGN AA, a network user failure event was included that intended to harmonise JGN's previous declared Retailer of Last Resort (ROLR) event with the network user failure event in the 2013-17 Envestra (Victoria) AA.[13] We suggest the JGN network user failure event definition should replace AGN's proposed definition as its specific reference to ROLR and the National Energy Retail Law improves the clarity of the definition and allows greater consistency across networks.

Significant Safety Event

AGN proposes replacing the existing natural disaster event with a significant safety event that would allow it to recover for situations that may not be categorised as a natural disaster. Origin suggests that should the AER approve this amendment, the definition should include a limitation whereby such events must be outside the direct control of AGN and cannot be attributed to any known party, for example the event is a result of actions by unknown upstream parties.

Improving Security of Supply Event

There have been a number of incidents in the past few years that have compelled AGN to consider options to improve security of supply of the network. As a result, it is now proposing to include a new security of supply event in the AA. Origin does not support this event as improving security of supply is standard business for AGN.

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[11] Ibid, pp. 262-3.
[12] AER, *Final 2015-2020 JGN Access Arrangement*, 3 June 2015, p. 10.
[13] JGN, *Proposed 2015-20 Access Arrangement Information*, 30 June 2014, pp. 135-6.

This event is intended to cover two activities. First, this event is intended to allow AGN to conduct assessments of network vulnerabilities and potential options to address these vulnerabilities. Assessing the security of supply is a standard function of the network and while we appreciate it may not be possible to scope the potential solutions now, AGN should at least be able to estimate a cost to complete the assessment process for inclusion in its AA proposal. As such, Origin does not support the inclusion of the improving security of supply event for this purpose.

Second, this event is intended to allow AGN to submit for the AER's approval a business case for actions to improve security of supply in accordance with the cost pass through provisions. Where there is a strong case for a particular supply solution, Origin considers that it should be progressed. However, we do not consider a pass through event for this purpose appropriate as improving security of supply is a standard function of the network and should form part of the AA.

In addition, there are practical difficulties with AGN's proposal which warrant this event not being included in the AA as any solution is likely to have other uses besides security of supply. For example, AGN discusses the option of constructing an LNG plant in or near Adelaide, together with mobile LNG equipment. This would provide a quicker and more effective response to emergency situations.[14] While other existing LNG plants and storage facilities, such as AGL's Newcastle Gas Storage Facility and the Dandenong LNG Facility, are intended to enhance security of supply, they also have commercial functions whereby gas can be provided to the broader market as required. A similar facility in SA could presumably provide similar commercial services thus excluding it from being a strictly security of supply solution that would meet the improving security of supply cost pass through criteria. Given it is unlikely a solution could be found that does not offer any associated commercial function, the improving security of supply event should not be included in the AA. Instead, all potential security of supply options should be managed through the existing AA process.

Significant Extensions Event

Origin does not support the inclusion of a new significant extensions event. Forecasting significant extensions is a standard function of the network and an integral element in the AA. We are concerned that the inclusion of this event would effectively allow AGN to bypass the AA process. The AA requires AGN to propose future expansion requirements based on sound and transparent demand forecasts and feasibility assessments. Through this process, AGN should be able to effectively forecast future demand requirements across its network over the next five years. It is hard to imagine a scenario where it could not foresee the need for a significant expansion over the AA period, particular in light of its forecast of slowing growth in customer connections. To suggest that such a scenario could transpire draws into question AGN's ability to effectively forecast demand across its network. AGN even notes elsewhere in its proposal that:

> It is rare for significant extensions of the Network to take place, and where they have occurred (for example in Tanunda and McLaren Vale); these are usually incorporated into AA forecast, thereby negating the need for AGN to apply to the AER for significant extensions.[15]

Should the AER see some merit in a significant extensions event being included in the AA, Origin suggests there should be a demand-based threshold to trigger the cost pass through event. For example, this could be based on new customer connections exceeding the current forecast of approximately 38,000 new customers by a certain percentage. Additionally, if this threshold were to be exceeded, this should not trigger an automatic pass through of costs. Instead, it should trigger an ex ante review of the event, which would include a thorough examination of the prudency for the

[14] AGN, *Proposed 2016-21 Access Arrangement Information*, July 2015, p. 265.
[15] Ibid, p. 282.

expansion and all the associated costs. This would confirm the significant expansion is in the long term interest of consumers.

2 Terms and Conditions

Origin appreciates the efforts made by AGN to consult on its Terms and Conditions with the Retailer Reference Group. Following this opportunity for retailer feedback on the Terms and Conditions, AGN has produced a document outlining its response to retailer comments, which has been included as attachment 17.2 to its Proposed AA Information.

This is a welcome improvement to the AA consultation process. AGN's response document has been particularly useful in simplifying our process to assess the proposal and formulate a response to the AER. Origin would like to see such a process undertaken by all networks going forward.

Origin considers AGN's proposed amendments are positive and have generally been made to:

- standardise terms across networks by reflecting decisions made by the AER on AGN's Victoria and Albury Terms and Conditions;
- incorporate changes necessary as a result of the introduction of the National Energy Customer Framework; and
- reflect the name change from Envestra to AGN.

We appreciate where AGN has accepted our comments on the Terms and Conditions. Origin makes the following comments for consideration by the AER. Most were provided to AGN but a sufficient reason has not been given for why the comment was not accepted. We have also included some additional amendments that were not included in our initial feedback to AGN. Our recommended improvements are intended to support retailers' ability to offer a high quality, efficiently priced service to customers.

2.1 Requests for Temporary Increase in MDQ – Clause 8.2

AGN proposes to increase the administration fee for requests for a temporary increase in MDQ from $200 to $250 and the hourly rate for engineering analysis from $100 to $150 per person per hour, which represent 25 and 50 per cent increases respectively. It suggests this is necessary because these fees have been unchanged for many years. In our view, however, one-off increases of 25 and 50 per cent appear excessive. Origin requests that the AER examine the reasonableness of these fee increases.

2.2 Metering Installation, Meter Accuracy and Scheduled Meter Reading – Clauses 9, 10 and 11

In response to our earlier comments, AGN recognised there are several instances of clauses in the Terms and Conditions that unnecessarily replicate obligations in the SA Retail Market Procedures. It stated it would review the need for these clauses with a view to eliminating duplication and thereby simplifying the Terms and Conditions.[16] Origin asks the AER to review these clauses to ensure that duplication between the Terms and Conditions and Retail Market Procedures has been removed.

2.3 Exclusion of Liability – Clause 14.2(a)

Under clause 14.2(a), AGN is excused from the obligation to deliver pressures within the range of pressures where a failure to comply is due to the technical, practical and physical limitations of the

[16] AGN, *Proposed 2016-21 Access Arrangement Information Attachment 17.2 – Engagement with the AGN Retailer Reference Group on Terms and Conditions*, July 2015, p. 3.

network whether or not AGN knew or ought to have known about the limitations in question. This reasoning seems very broad. AGN's principal responsibility is to deliver gas to customers at the correct pressure. It would be hard to imagine a scenario where it could not point to this clause for reasons other than insufficient gas being delivered or gas being delivered by a third party at pressures outside of the required limits. We request that the AER assess whether this clause is too broad and as a result, whether it is appropriate to limit adverse consequences to customers.

2.4 Control and Possession – Clause 15.1(b)

AGN's proposed deletion does not align with the SA Retail Market Procedures under which a user cannot be held to be in possession of gas delivered to any user delivery point. A user can only be held to be in possession of gas delivered at a user delivery point that it is the user for. As such, Origin suggests the proposed deletion should not be accepted and the original wording of this clause should be retained. If AGN's proposed drafting was accepted, not only would there be a misalignment between the AA and Retail market Procedures but a situation could arise where one user could lay claim to gas delivered at another user's delivery point. Resolving this issue could be unnecessarily complex and costly, with costs ultimately borne by customers.

2.5 Content of Statement of Charges – Clause 21.2

Origin suggests this clause be amended as follows:

> Each statement of charges must include the information required by law together with any other information reasonably required by the Agreement <u>and as agreed between the Network User and AGN</u>. A statement of charges may also include any other information which AGN decides or agrees to include.

This is intended to ensure that all relevant information is provided by the network to ensure that retailers are able to pass all relevant charges to the customer. AGN's response to our earlier comment notes that NGR 506(3) states that the format of a statement of charges must be as agreed between the retailer and distributor or, in default of agreement, as reasonably determined by the distributor. We see no issue with this being codified and clarified in the Terms and Conditions.