5 February 2019

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

Email: NSW2019-24@aer.gov.au

Dear Mr Roberts

RE: AER DRAFT DECISION 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 2019-20 to 2024-25.

Origin supports the significant progress that the AER has made in driving the NSW networks towards achieving more efficient expenditure levels. However, we remain concerned that despite the maturity of the regulatory regime, governance and management processes still detract from the ability of the networks to make prudent and efficient expenditure decisions.

It is vitally important that all expenditure, and especially capital expenditure, is demonstrated to be the most prudent and efficient long-term solution to a network problem. We believe that when asset management frameworks have shown to be persistently below the required standard that the risk of incorrect investment decisions must be borne by the networks businesses. While lower rates of return have subdued this risk in recent years, this may not be the case for future regulatory periods.

Origin recognises that each of the NSW networks have taken significant steps to transition to more sustainable levels of underlying operating expenditure. While we accept that the magnitude of efficiency gains achieved over the last regulatory period is not sustainable, we do not support the AER's draft decision not to include a productivity growth factor for this regulatory period. We believe that the AER ought to reasonably reflect productivity expectations by including a productivity growth rate consistent with its draft decision paper on forecasting productivity growth for electricity distributors.

We also remain concerned about the broader approach to implementing network tariff reform. The key pre-conditions for the success of this reform is having customers who understand the price signals being sent and are therefore able to make informed decisions in response; necessary technology is also a key enabler. To date we believe there has been the absence of a broad-based and coordinated education campaign that provides consumers with the understanding and tools they need to make fully informed decision. In this regard, we agree with the views raised by the ACCC in their retail pricing inquiry that there may be the need for government communication campaigns in conjunction with retailers and networks to explain to customers how they can manage the potential impacts of these reforms. In the absence of such a campaign, retailers are unlikely to expose their customers to tariffs they will not understand or find confusing.

Furthermore, it is vitally important that the AER consider the implications of how tariff reform will interact with other key retail tariff reforms such as the default market offer (DMO) and the Victorian default offer (VDO). It is essential that there is consistency in these reforms to ensure that each party in the supply chain has a reasonable opportunity to manage their financial risks.

We would also like to recognise the improved engagement by the NSW networks in the development of these regulatory proposals, notably Essential Energy.

Origin's responses to specific issues identified in the approach paper 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 has applied the approach from its recent draft decision on the review of its rate of return guideline. While the guideline was a draft, the AER has undertaken an extensive consultation process and all participants are fully aware of the AER's position on methods and parameter values. Once finalised, the guideline will also apply to all future network determinations. On that basis, we believe it was sensible decision to apply the draft guideline in the AER's draft decision.

The AER has subsequently finalised its rate of return review. We fully anticipate that these guidelines will continue to apply to determine the rate of return in the final determination. We have previously stated out support for the AER's positions from its rate of return review and we re-state our support in this submission.

Operating Expenditure

Origin recognises that each of the NSW networks have taken steps to transition to more sustainable levels of underlying opex. We also recognise that the reductions achieved over the 2014-19 regulatory period are not sustainable long-term.

The AER has applied an approach where productivity growth forecasts do not include any productivity growth required for an inefficient firm to catch-up to the productivity frontier on the basis that the efficiency adjustment is made to the base opex. We note that the revealed opex of each of the networks has now converged towards efficient levels. However, we expect that an efficient and prudent network would embark on continual process and productivity improvements. On that basis, we believe that the AER ought to reasonably reflect productivity expectations by including a productivity growth rate consistent with its draft position on forecasting productivity growth, rather than the zero per cent adopted in its draft decision.

To support this view, given the magnitude of the productivity gains proposed by Essential, it also seems implausible that neither Ausgrid nor Endeavour have proposed any productivity gains.

With respect to demand management, Origin fully supports initiatives that promote non-network solutions aimed at reducing the overall capital spends of the businesses. However, like any investment proposal there must be a prudent and efficient substitution between capex and opex. For this reason, we support the AER's decision to not accept demand management proposals where the networks have not demonstrated that there is a net benefit to consumers.

Capital Expenditure

To assess the efficacy of each of the NSW networks' asset management frameworks, the AER engaged Energy Market Consulting associates (EMC) and Arup. In the case of Ausgrid and Endeavour, EMC identified that that the respective governance and management processes detract from the networks' capacity to make prudent and efficient expenditure decisions. EMC also concluded that a forecast produced through these governance processes is not a reasonable forecast of prudent and efficient requirements.

In the absence of robust risk-based cost-benefit analysis, the AER must make a decision based on the best information and resources available to it; in the case of Endeavour and Ausgrid this is the AER's own augex and repex modelling. As the AER has stated, these results do not necessarily mean it will reject a network's costs deterministically, but the onus must be on the network to provide a sufficiently justified alternative. Until such time that Ausgrid and Endeavour can demonstrate that their proposed expenditure is supported by robust risk-based asset management techniques, we support the AER applying its regulatory judgment to determine an alternative value.

We note that the forecast utilisation rates of the networks are showing constant to modest increases over the next regulatory period but remain below historical levels. For these reasons we support the AER's position on augmentation capex.

However, while augex costs are moderating, repex and non-network costs remain persistently high; notably for Ausgrid and Endeavour. We understand that the drivers of repex will be the age and condition of the assets and whether replacement is the most economic option. Given the findings of EMC regarding the integrity of some of the cost benefit analysis undertaken by the networks, we support the AER in taking a conservative approach to approving repex programs until such time as the networks are able to demonstrate the prudency and efficiency of their investment.

Similarly, we are concerned at the level of increases in non-network costs and support the AER ensuring that these levels remain consistent with trends in overall costs. With respect to overheads, this accounts for broadly a quarter of the proposed capital costs. Reductions made to the capital programs have not been directly reflected in a commensurate reduction to the overhead allowance. We understand that there is not a proportionate relationship between movements in capex and overheads, however, we would expect a ratio of movement greater than a 1 to 4 ratio as applied in the Ausgrid assessment. Furthermore, we believe it would be insightful for the AER to directly compare the direct and indirect overheads for both capex and opex of each of the networks as a percentage of direct spend to allow for a comparison of the respective efficiencies in overhead allocation.

Tariff Structure Statements

Origin has previously recognised the importance of reforming network tariffs. However, we remain concerned that some tariff structures approved by the AER are too complex for the vast majority of consumers to understand and therefore respond to.

We retain the view that tariff reform must be considered part of a suite of approaches to be used to reduce demand on the networks. These include controlled load and other demand managements strategies.

We also believe there needs to be better education of customers before exposing them to tariffs they are unfamiliar with or are complex. This 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. The absence of a broad based and coordinated education campaign remains the largest impediment to the successful implementation of network tariff reform.

There also needs to be recognition that effective smart demand response technology that enables greater energy management is not yet sufficiently available or economic for the vast majority of residential customers. 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, we believe incentive-based demand management initiatives may provide a more effective outcome in the short-term.

Furthermore, it is vitally important that the AER consider the implications of how tariff reform interacts with retail tariff reforms such as the default market offer (DMO) and the Victorian default offer (VDO). It is essential that there is consistency in these reforms to ensure that each party in the supply chain has a reasonable opportunity to manage their financial risks.

Closing

Origin supports the progress that the AER has made in driving the NSW networks towards achieving more efficient expenditure levels. However, we remain concerned that despite the maturity of the regulatory regime, governance and management processes still detract from the ability of the networks to make prudent and efficient expenditure decisions.

Despite these significant improvements, we believe that a reasonable expectation is that some degree of productivity gain can still be achieved over the next regulatory period.

We also remain concerned about the approach to network tariff reform. While Origin supports the need for tariff reform to provide pricing signals to consumers regarding the costs of their usage, it is necessary that these reforms are underpinned by an education campaign that provides consumers with the understanding and tools they need to make fully informed decision.

Furthermore, it is vitally important that the AER consider the implications of how tariff reform interacts with other retail tariff reforms such as the default market offer (DMO) and the Victorian default offer (VDO). It is essential that there is consistency in these reforms to ensure that each party in the supply chain has a reasonable opportunity to manage their financial risks.

We would also like to recognise the active engagement of both the AER and the network businesses as part of the development and assessment of regulatory revenues and tariffs to apply in the next regulatory period.

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

Yours sincerely

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