8 August 2014

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

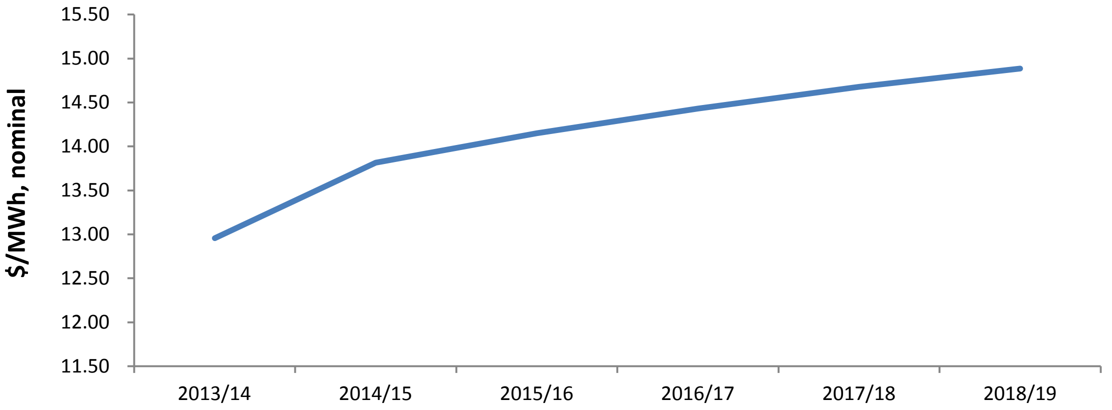
Dear Mr Anderson

RE: SUBMISSION TO TRANSGRID'S REGULATORY PROPOSAL

Origin Energy Electricity Limited (ABN 33 071 052 287, "Origin") appreciates the opportunity to provide input to the Australian Energy Regulator's (AER) deliberation over the regulatory proposal submitted by New South Wales electricity Transmission Network Service Provider, (TNSP) Transgrid under the National Electricity Rules to determine its revenue allowance for the period 2015-19.

At a high level Origin notes that customers' prices will increase in nominal terms over the period, as outlined in Figure 1. Origin questions whether this is consistent with "marked changes in trends for peak demand growth across New South Wales and the Australian Capital Territory"[1], a much reduced cost of capital, significant capital investment in the prior period, and a more than halving of the capital expenditure program.

Figure 1. Transgrid, proposed average price increases (nominal), 2014-19



Source: Transgrid Post-Tax Revenue Model

1. Cost of capital

Transgrid proposed a Weighted Average Cost of Capital (WACC) of 8.83 percent. Origin observes that this WACC appears excessive given the business operates in monopoly conditions, with a revenue cap and a pass through mechanism covering multiple events.

[1] Transgrid Regulatory Proposal, p.32

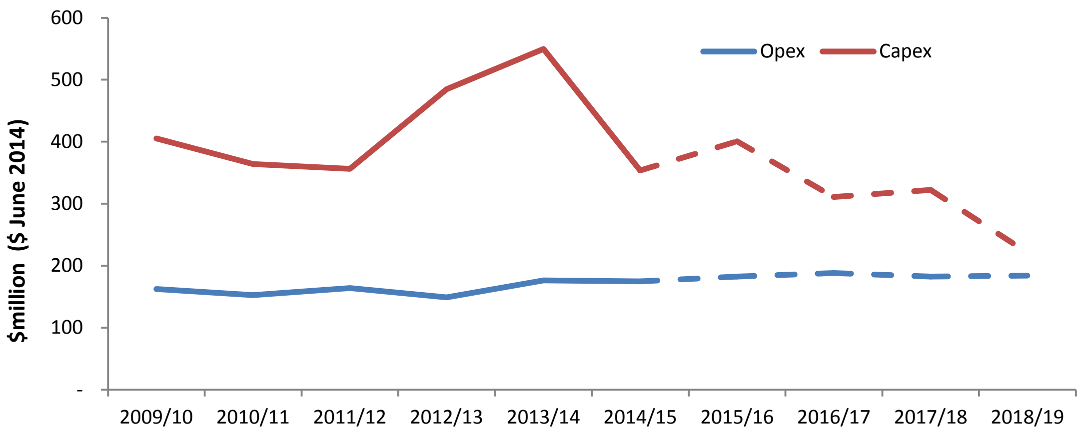
Origin notes also that the AER found in its transitional decision Transgrid had "overstated its WACC and that its estimate did not appropriately take into account the available market information and expected market trends reflected in recent debt market data and in the return on equity analysis set out in the rate of return guideline."[2] In light of this, Origin encourages the AER to investigate what has led Transgrid to propose a WACC equivalent to that proposed for the transitional year, since key metrics in relation to the cost of debt and equity have not changed significantly in the intervening months.

Origin appreciates that the AER is required to set the WACC at the level of an efficient business, rather than at the actual cost of capital faced by the TNSP, but urges the AER to exercise its discretion to select values at the lower end of the range permitted, values closer to the actual cost of capital the TNSP faces. If the AER were to select a WACC of 7.6 percent, being the bottom end of the range of appropriate WACCs identified in the Transitional Decision, this would deliver a significant saving to customers relative to the proposed WACC of 8.83.

2. *Operating expenditure*

Origin notes that Transgrid proposes an operational expenditure program in line marginally larger than during the 2010-14 regulatory period, growing at 1.3 percent above CPI on average over the period. This outlined in Figure 2, alongside historic and proposed capital expenditure.

Figure 2. Transgrid: historic and proposed operating and capital expenditure, 2009-14, 2015-19



Source: Transgrid consolidated RIN

Origin questions the appropriateness of this in light of the significant increase in capital spending over the last regulatory period and the subsequent change in demand, both of which should have reduced maintenance costs relative to the prior period. Equally, a 60 percent reduction in the capital expenditure program should deliver some savings in terms of operational expenditure.

Demand management program

Origin notes that Transgrid proposes to increase funding for its demand management program from $5 million in the 2010-14 regulatory period to $18 million in the 2015-19 regulatory period, an increase of some 360 percent. Transgrid reports that:

The past few years have seen marked changes in trends for peak demand growth across New South Wales and the Australian Capital Territory. This has largely been driven by consumer response to energy efficiency policies, green energy policies, the impact of global economic conditions on major industry and consumer confidence, and electricity price increases.

[2] AER, Transitional decision TransGrid and Transend 2014-15, March 2014 p.27

Against this backdrop Origin questions whether a more than tripling in spending on demand management programs is appropriate.

Core elements of Transgrid proposed demand program relate to improving understanding of the value of demand management among customers.[3] While aTNSP may have a role to play in increasing understanding of demand management among customers, its interaction with customers is typically concentrated on the largest customers, and the latter normally have a sophisticated understanding of the value of demand management to their businesses. Small customers interact with the industry more regularly via retailers and to some extent distribution network businesses (DNSPs). In this context it appears relevant that a significant proportion of the projects outlined in Transgrid's "Key findings from Demand Management Incentive Allowance 2009-14" were projects undertaken in collaboration with DNSPs. The AER should ensure that:

- the parties best placed to undertake these activities are funded to do so;
- that funding is appropriate relative to changes in demand conditions and does not exacerbate the problem of network prices rising to recover return on capital over shrinking volumetric consumption;
- where the need is being met by participants in the competitive energy market that this is not duplicated through regulated revenues.

Furthermore, to the extent that these programs deliver savings against the baseline these should be reflected as savings in capex.

Labour cost escalators

Origin questions whether using costs associated with current Enterprise Bargaining outcomes is consistent with incentives for the business to behave as a benchmark commercial entity that would normally negotiate throughout the period of an agreement to secure productivity gains at the margin. In this vein Origin highlights the AER's preference not to use these costs as the basis for forecasting labour escalators, as outlined in the Draft and Final Decisions covering the Victorian DNSPs in 2011.[4] At a broader level Origin notes that there is some discontinuity between a cost of capital that assumes a benchmark entity subject to commercial risk, and an allowance for labour costs that assumes no pressure on the entity to pursue improved outcomes from labour relations over the remaining term of employment agreements.

In addition, Origin notes that following the expiry of the agreements, labour cost escalators towards the end of the period are above long term averages. The consultants to Transgrid, BIS Shrapnel, note:

As mentioned, wages growth in the utilities sector since 1997 has outpaced the national 'all industries' average. To a large extent, this has been underpinned by strong capital works program in the utilities sector since the beginning of the last decade (resulting in robust employment growth over the same period), strong competition from the mining and construction workers for similarly skilled labour and the powerful influence of unions in the utilities sector.[5]

In contrast to the prior period:

- the three NSW DNSPs, being the largest employers of technical labour in the electricity utilities in that state, will be involved in a coordinated and sustained campaign of redundancy over the period, which will put downward pressure on wages in the sector as well as on the ability of employee advocates to extract above average price increases;
- the NSW Government intends to privatise Transgrid and the three DNSPs, which in the Victorian case led to a more pro-active management of labour costs;
- the most recent boom in the resources sector (associated with gas export projects) is moving in to its less capital-intensive production phase.

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4 AER, Draft decision Victorian electricity distribution network service providers Distribution determination 2011–2015, Appendices, June 2010, page 136, and as confirmed in the final

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All these factors imply a period of growth in wages below long term averages, rather than the opposite. Origin recognises the AER will seek an independent forecast view on labour cost escalators and suggests a revision downwards in these indicators may be appropriate.

3. Capital expenditure

Transgrid has proposed a capital expenditure program for the 2014-19 regulatory period that is 20 per cent lower in nominal terms than the program for the 2009-14 regulatory period.

The key driver for this difference is a 84 per cent reduction in augmentation capex.

A significant reduction in growth driven capex would be expected given the weakness in consumption and demand growth relative to the previous regulatory period. However, with a reduction in growth capex there is a corresponding increase in replacement capex.

In the early part of the 2009-14 regulatory period replacement capital expenditure remained relatively stable at around $120M per annum. However, from 2012/13 to 2013/14 there was a significant and unprecedented jump of 65 per cent. Furthermore, replacement capex has remained at these levels in the interim, resulting in a 73 per cent increase in expenditure relative to previous regulatory period.

Origin recognises that transmission investment can be lumpy and as a result the profile of will not be as continuous as it would for say a distribution business. This lumpiness notwithstanding, the step change in replacement capex is significant and warrants close scrutiny. Origin notes that Transgrid has claimed confidentiality over its repex RIN template. As a result, stakeholders are prevented from making an informed contribution regarding the appropriateness of the replacement program which accounts for 70 per cent of the total proposed capital program.

Origin considers that a confidentiality claim of this breadth is unacceptable, especially for a regulated natural monopoly business that does not face the same commercial sensitivities of businesses in a competitive environment. Origin encourages the AER to provide greater transparency of the replacement capex so that stakeholders can be actively involved in the regulatory process as we understand is the intent of the regime.

If you have any questions regarding this submission please contact Steven Macmillan in the first instance on (02) 9503 5005.

Yours sincerely

Keith Robertson
Manager, Wholesale and Retail Regulatory Policy