4 February 2016

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

Dear Mr Anderson

RE: AGN REVISED ACCESSS ARRANGEMENT

Origin Energy (Origin) appreciates the opportunity to provide input to the Australian Energy Regulator's (AER) assessment of the access arrangement submitted by Australian Gas Networks (AGN) for the South Australian Natural Gas Distribution Network for the period 2016-21.

In our previous submission, we recognised the effort that AGN had undertaken to engage with retailers as part of the development of its access arrangement. While AGN and Origin have not always agreed, it has been a constructive process and we appreciate AGN's approach.

In terms of its revised access arrangement, we also recognise that AGN has accepted many aspects of the AER's draft decision in order to focus the debate on material issues; notably the rate of return and the mains replacement program.

Origin's comments on these and other specific issues are set out below.

Capital Expenditure

AGN put forward a net capital program of $687.3M, largely driven by its main replacement program which accounted for 54 per cent of these costs. AGN's proposed program of work compares to $392.6M of net capital incurred for the 2010-15 access period.

The AER notes that AGN has not provided a rigorous quantitative risk assessment to demonstrate that the rate of mains replacement over the 2016-20 period is prudent and efficient. Further, the AER notes that it has limited information and data to derive an alternative efficient estimate.

Without an adequate quantitative asset management assessment it is not clear how a prudent program of work can be developed that achieves an optimal balance across the key parameters of unaccounted for gas, regulatory service obligations, risk and costs to consumers.

Origin is strongly of the view that the onus must be on AGN to demonstrate that any revised proposal is underpinned by prudent asset management systems operating consistent with good operating practice and that these systems are using robust and reliable data. Where this is not made available, Origin considers that the AER must apply a conservative approach to determining an alternative value of conforming capex.

Weighted Average Cost of Capital

As part of its initial access arrangement, AGN proposed a cost of debt using the application of a 10-year transition to the base interest rate only (assuming 100% of the base rate is hedged), with no transition applied to the debt risk premium (DRP). In addition, it proposed a multi-model approach to the calculation of the return on equity.

In our response, we supported the method adopted by the AER of a 10 year transition to a trailing average benchmark debt rate as well as its foundation model for the derivation of the cost of equity.

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In its revised access arrangement, AGN proposed a number of alternative methods for the calculation of the cost of debt. Notwithstanding, it concluded that if it is later held by the Australian Competition Tribunal that it is bound to elect an alternative, it elects that there should be a transitional hedging of the base rate only to the proportion of the base which is efficient to hedge with no transition of the remaining proportion and an immediate move from the on-the-day approach to determining the debt risk premium to a trailing average.

AGN argues that application of a transition that results in the return on debt being different from efficient financing costs will, by definition, lead to an allowance that is not commensurate with the efficient debt financing costs of a benchmark efficient entity.

In previous submissions on this issue, Origin has noted that as part of its rule determination relating to the economic regulation of network service providers (ERC0134), the Australian Energy Market Commission (AEMC) did not mandate any particular approach to estimating the return on debt. Instead, the final rule sets out at a very broad level the characteristics to estimating the return on debt that could reasonably be contemplated by a regulator. Furthermore, the AEMC intended the regulator to have the discretion to propose an approach and that this judgement is to be exercised in such a way as to be consistent with the overall allowed rate of return objective.[1]

While the AEMC delegated discretion to the AER in terms of the approach and application of a calculation of cost of debt, it nevertheless considered the issue of transitioning. Specifically, the AEMC engaged SFG Consulting (SFG) to provide advice on a range of matters associated with the regulatory rate of return. SFG concluded that the type of "rolling in" arrangement that has been proposed by Queensland Treasury Corporation would be an effective means of transitioning from the current rules to the use of an historical average cost of debt approach.[2]

SFG also noted that if the regulatory allowance was set by not allowing an appropriate transition arrangement, the result would be either a potentially material benefit or loss to the business – and conversely a potentially material loss or benefit for customers. Moreover, an appropriate transition arrangement effectively destroys any incentive or ability for a business to seek to "game" the regulatory allowance by proposing whichever method might result in the highest allowance.

Notwithstanding the information presented by AGN, we maintain our position that the AER has exercised its judgement to arrive at a method to estimate the cost of debt consistent with the AEMC's policy intent and we support its transition approach.

In terms of the cost of equity, during the Guideline development process, the AER explored the options of adopting a primary model, a primary model with reasonableness checks, several primary models with fixed weights or a multi-model approach.

The AER adopted the position that it must have regard to all relevant material submitted, including outcomes from the different asset pricing models (i.e. the SLCAPM, Black CAPM, FFM and DGM). When having regard to relevant evidence, the AER has undertaken to apply its judgement to determine how it can best incorporate this evidence into its return on equity estimate.

In decisions made to date, the AER has relied principally on the output of the SLCAPM. Origin has supported this approach in the past and we maintain our view that the AER has no reason to expect that adjusting the method it has adopted to date would better contribute to the achievement of the allowed rate of return objective.

For these reasons, Origin maintains its view that the AER has adopted a balanced and pragmatic approach that provides certain and predictable outcomes for investors and provides a balance

[1] AEMC, Rule Determination, National Electricity Amendment (Economic Regulation of Network Service Providers) Rule, 2012, p. 90.

[2] SFG Consulting, Rule change proposals relating to the debt component of the regulated rate of return, Report for AEMC, 21 August 2012, p. 46.

between the views of consumer groups and the network businesses. We strongly encourage the AER to not accept the revised rate of return proposals put forward by AGN. For further detail on our position with respect to WACC we refer the AER to our previous submissions in response to submissions lodged by the electricity distribution network businesses.

Unaccounted for Gas

Unaccounted for gas (UAFG) costs are currently determined as the product of forecast volume losses and wholesale gas prices and are included in forecast operating costs.

The AER notes that the Australian Energy Market Operator (AEMO) is currently undertaking a review of the arrangements for the treatment of UAFG, and is considering a proposal to transfer responsibility for supplying UAFG from networks to retailers and self-contracting users.

Origin had previously made comments to AEMO supporting in principal the proposal to transfer responsibility for supplying UAFG from networks to users and self-contracting users. However, following further investigation and consideration, we consider that the net benefit to implement this approach was marginal at best.

Notwithstanding, we support the position taken by the AER that it should not pre-empt the outcomes of the AEMO review and must assess AGN's forecasts of UAFG costs based on the arrangements that are in place at this time. For this reason, we support the arrangements proposed in the AER draft decision where tariffs are adjusted annually to reflect movements in wholesale gas prices rather than UAFG volumes.

Incentive Mechanisms

As stated in previous submissions, Origin is supportive of an incentive based regulatory regime. We believe that a regulatory framework should consist of multiple mechanisms that are sufficiently synchronised to ensure a correct balance of incentives and penalties. It is it is imperative that the AER has confidence that each of its incentive regimes will operate in tandem and deliver long-term intended outcomes. Failure to have a complete set of instruments creates opportunities for gaming or unintended consequences.

For these reasons, we seek confirmation from the AER that the absence of a Capital Expenditure Sharing Scheme will not create unintended consequences on other aspects of the regulatory arrangements and that the regulatory framework delivers the right balance of incentives and penalties.

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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