6 February 2015

Mr Chris Pattas
General Manager - Network Investment and Pricing
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Submitted by e-mail: TransGridrevenuereset@aer.gov.au

Dear Mr Pattas

RE: SUBMISSION TO AER TRANSGRID DRAFT DETERMINATION

Origin Energy Electricity Limited (ABN 33 071 052 287, "Origin") appreciates the opportunity to provide a response to the Australian Energy Regulator's (AER) Draft Decision with respect to the determination of regulatory revenue allowances for TransGrid for the period 2014-15 to 2017-18.

The AER's decision is the first determination following changes to the National Electricity Law and National Electricity Rules in 2012. As a result, the AER has adopted a more holistic approach to decision making where it approves total expenditure allowances, not programs or projects. Origin agrees in principle with the approach taken by the AER to adopt a less prescriptive and granular approach to assess proposed costs and delegate greater responsibility to the businesses on how they manage their revenue allowances.

Regarding the draft determination itself, Origin considers the AER's approach to determining capital expenditure is broadly appropriate. In determining the appropriate level of capital expenditure, the AER should be cognisant of the difference between distribution and transmission businesses, with the reliability and performance of the latter having a key role in promoting efficient wholesale dispatch and spot market outcomes.

In assessing operational expenditure, Origin supports, in principle, the AER's approach to implementing the base step trend Approach. We support the AER's assessment not to allow the majority of TransGrid's step change costs on the basis that the proposed expenditure represents business as usual processes rather than new regulatory obligations. We consider the treatment of provisions must be consistent across all regulatory decisions.

In Origin's view, the AER has estimated a cost of equity that considers relevant material, provides certain and predictable outcomes for investors, aligns with stakeholder expectations and is consistent with the rate of return objective. We consider there is insufficient evidence to support the assertion that a transition to a trailing cost of debt approach will not provide TransGrid with an opportunity to recover at least efficient financing costs.

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In the balance of this submission, Origin provides specific comments relating to capital expenditure, operating expenditure and the regulatory rate of return.

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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1. Capital Expenditure

Summary

Origin considers the AER's approach to determining capital expenditure is broadly appropriate. In making its determination, the AER should be cognisant of the difference between distribution and transmission businesses, with the reliability and performance of the latter having a key role in promoting efficient wholesale dispatch and spot market outcomes.

AER draft determination

TransGrid proposed capital expenditure of $1,387.44 million[1] with a 40% increase in replacement capex (repex), with augmentation expenditure (augex) representing 10% of total capital expenditure.

In its Draft Decision, the AER approved $922.3 million in capex, comprising a 30 percent reduction in repex and 85 percent reduction in compliance expenditure relating to the remediation of low transmission spans.[2] This represents a 34% reduction relative to the program proposed by TransGrid.

The AER broadly approved TransGrid's proposed augex, but imposed reductions on expenditure related to: (1) strategic property acquisitions; (2) security and compliance; and (3) other asset specific projects relating to substation renewal, secondary systems, line renewal and TransGrid's communications strategy.

The capex program TransGrid put forward in its proposal is significantly different from any period in recent history. Historically, capex has been driven by electricity use growth, but the significant changes in electricity usage have resulted in a much lower need for load driven investment over the next five years. In contrast, repex has increased significantly compared to the last five years, reflecting the age of many of TransGrid's assets, built during the establishment of the transmission network in the 1950s and 1960s, which are reaching the end of their serviceable lives.

The AER has raised questions around the approach TransGrid has put forward to determine the need for asset replacement and refurbishment. In particular, it considers TransGrid's proposed economic methodology approach for assessing the condition risks of assets overestimates those future risks, which in turn, overstates TransGrid's forecast repex needs in the order of 20% to 30%. Under TransGrid's new approach, assets are not automatically replaced on a like-for-like basis, but are optimally configured for future load requirements identified through efficient asset management decisions.

For key elements of the repex program, the AER does not consider TransGrid has: (1) identified opportunities to defer and/or reduce the scope of repex projects; (2) demonstrated consideration for lower cost alternatives; or (3) provided evidence of performance issues that would support the substantive increase in replacement needs.

Origin's position

Based on the information available, Origin considers the AER's approach to determining capital expenditure is broadly appropriate, noting that the AER's Draft Decision results in

[1] AER 2014, 'Draft Decision, TransGrid Transmission Determination 2015-16 to 2017-18 Overview', November 2014. p. 45.
[2] AER 2014, 'TransGrid transmission determination 2015-16 to 2017-18, Draft decision,' November 2014, Melbourne. pp. 45-47.

a large reduction in capital expenditure compared to that originally proposed by TransGrid.

In determining the appropriate level of capex, Origin considers that the AER will have regard to the role of efficient transmission investment in delivering optimal network performance to support efficient dispatch and prices in the wholesale electricity market.

2. Operating and Maintenance Expenditure

Summary

Origin, in principle, supports the AER's approach to implementing the base step trend approach. We support the AER's assessment not to allow the majority of TransGrid's step change costs on the basis that the proposed expenditure represents business as usual processes rather than new regulatory obligations. We consider the treatment of provisions must be consistent across all regulatory decisions.

AER draft determination

TransGrid proposed a forecast opex of $754.6M (real 2013–14)[3] for the 2014–18 period. This represents an annual average increase of 14.2% when compared to average annual actual opex over the 2009–14 period.

The AER accepted TransGrid's operating expenditure in 2012-13 as efficient base year expenditure. However, it did not accept TransGrid's proposed step change costs or expenditure trend.

Origin's position

TransGrid proposed a number of step change costs, most notably, $9M for consumer engagement, $10.4M to promote demand management and $7.6M for various regulatory obligations.

Origin agrees with the AER's assessment that customer engagement and regulatory reporting obligations represent business as usual obligations and should not be considered as step change costs. In addition, given current demand projections, we question the cost benefit tradeoffs of additional allowances for demand management innovation at this point in time.

Origin also agrees that the onus must be on TransGrid to provide sufficient justification for its step change demonstrating that there is a net positive value resulting from the expenditure and the additional expenditure is in the long term interests of consumers.

The AER has assessed base year opex exclusive of any movements in provisions. Under this approach, TransGrid's opex forecast has increased by $60.6 million (real 2013–14). Origin accepts that employee entitlements are accrued employee benefits that TransGrid is required to recognise and fund. However, Origin considers that provisions must be assessed on a cash basis and reflect TransGrid's actual annual obligations. This should also extend to any assessment of efficiency reward. Furthermore, the assessment of provisions in the opex allowance and their treatment in any efficiency mechanism must be consistent across all AER regulatory assessments.

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[3] AER 2014, 'TransGrid Transmission Determination 2015-16 to 2017-18 Attachedment 7: Operating Expenditure', p. 7-7.

In terms of the AER's trend analysis, Origin considers that the calculation of the annual rate of change should be consistent with the approach to derive the efficient base. In doing so, Origin encourages the AER to accept efficient escalation rates over potentially entrenched arrangements, especially with respect to employee labour agreements.

3. Cost of Capital

Summary

In Origin's view, the AER has estimated a cost of equity that considers relevant material, provides certain and predictable outcomes for investors, aligns with stakeholder expectations and is consistent with the rate of return objective. We consider there is insufficient evidence to support the assertion that a transition to a trailing cost of debt approach will not provide TransGrid with an opportunity to recover at least efficient financing costs.

3.1. Cost of Equity

AER draft determination

TransGrid proposed a nominal post–tax return on equity of 10.5% derived from a multiple model approach. TransGrid does not consider that that the AER's approach considers all relevant information in calculating an appropriate cost of equity and that the application of the AER's foundation model is inconsistent with a market practitioner's approach.

In its Draft Decision, the AER did not accept the cost of equity proposed by TransGrid, approving an alternative estimate of 8.1%.

The AER agreed with a number of aspects of TransGrid's rate of return proposal. However, the AER considered that where TransGrid departed from the approach set out in the Rate of Return Guidelines, it was not satisfied the result better achieved the allowed rate of return objective.

TransGrid argues that the AER estimate does not allow it to recover its efficient costs and that a higher return of equity is warranted.

Origin's Position - Cost of Equity

The AER's objective is to estimate an expected return on equity commensurate with the risks of a benchmark efficient entity providing regulated network services.

The development of the AER's Rate of Return Guidelines has been subject to robust and extensive consultation and review. These Guidelines sets out the methodologies the AER will use in determining a return on equity and a return on debt for in its regulatory determinations.

A key objective for the AER is to ensure that the return on equity for a regulatory control period is estimated such that it contributes to the achievement of the allowed rate of return objective. The allowed rate of return objective means the rate of return for a regulated business is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk and having regard to the prevailing conditions in the market for equity funds.

The AER has applied its foundation model, the Sharpe-Lintner Capital Asset Pricing Model (SLCAPM) to determine the rate of return. In its application, the AER has considered a

broad range of relevant information to determine input parameter point estimates to be used to inform the overall return of equity.

Origin notes that TransGrid has already put forward extensive arguments in response to the AER's Guidelines regarding the application of the SLCAPM; the AER has already considered and not accepted these arguments. Origin accepts that regulated businesses may propose departures from the Guidelines. However, it is not clear that the position put forward by TransGrid provides sufficient new arguments that would warrant a departure from the position already deliberated on by the AER.

Nevertheless, Origin does not agree that failure to adopt TransGrid's approach would prevent it from recovering its efficient costs. Origin considers that the AER's approach produces an estimate of the cost of equity that is consistent with historic regulatory decisions and reflects the efficient financing costs of a business exposed to the level of risk that applies to an Australian regulated business.

In this regard, Origin agrees with the AER's consultants (McKenzie and Partington) that concluded:[4]

> …it is hard to think of an industry that is more insulated from the business cycle due to inelastic demand and a fixed component to their pricing structure. In this case, one would expect the beta to be among the lowest possible and this conclusion would apply equally irrespective as to whether the benchmark firm is a regulated energy network or a regulated gas transmission pipeline.

Furthermore, Origin considers that there is clear support from stakeholders and customers across all regulated energy businesses for lower returns given recent increases in network costs. Despite recognising this point in its proposal, TransGrid has proposed a return on equity significantly higher than the rate calculated by the AER.[5] Origin also considers that this higher relative return will simply result in higher network charges without any commensurate increase in transmission services.

Origin considers that the method put forward by TransGrid does not provide sufficient transparency regarding the key risk and reward trade-off. Furthermore, we consider the material relied upon by the AER produces an estimate that better reflects the efficient financing costs of a business exposed to the level of risk that applies to an Australian regulated business and should be preferred over the estimate provided by TransGrid.

3.2. Return on Debt

AER draft determination

TransGrid proposed a return on debt estimate of 7.72%, based on an immediate transition to the 10 year trailing average approach set out in the Rate of Return Guidelines.

The AER's draft decision is for a cost of debt of 6.51%. To ensure the changes to the regulatory approach to WACC do not disadvantage businesses that have previously entered into long term risk management arrangements, the AER has set out a transitional arrangement that helps mitigate any mismatch between the costs allowed and those incurred over the 10 year period following the adoption of the new regime.

TransGrid argued that a transition to a trailing average approach is unwarranted for businesses that currently manage a staggered debt portfolio and do not use interest rate

[4] AER Draft Decision, Attachment 3: Rate of Return, p. 236.
[5] TransGrid Revised Regulatory Proposal, p.115.

swaps. It also argues that its imposition will result in a substantial cost, or windfall loss, that could otherwise be avoided and is contrary to the intention of the NER.

Furthermore, TransGrid claimed that given the significant size of its debt portfolio and the depth of the interest rate derivative market, there is a real risk that they would not be able to hedge their cost of debt allowance using interest rate swaps. In addition, it argued that even if they were able to: (1) refinance their entire debt portfolio over a short-term averaging period; or (2) use interest rate swaps to match its actual costs to yields observed over a short term averaging period; the pricing of the debt would not be efficient and would come at a significant cost. It, therefore, argued that a short-term averaging period approach reflects a clearly inefficient approach to managing debt for a benchmark efficient business with the size of its debt portfolio.

Origin's Position - Return on Debt

Origin understands that TransGrid secures debt financing through NSW Treasury Corporation. This arrangement provides that NSW Treasury Corporation is the mandated Debt Advisor to the regulated electricity utility sector. For these clients, NSW Treasury Corporation provides advice on liability management strategies, debt benchmarks and market execution strategies, but the clients manage the execution task themselves.[6]

Despite the fact that the cost of debt of the benchmark efficient entity is based on bond yield data for BBB+ and BBB rated Australian corporate bonds, NSW Treasury Corporation debt issuances reflect the State's AAA credit rating.[7]

To ensure the NSW DNSPs do not receive a competitive advantage as a result of NSW Treasury Corporations AAA credit rating, the NSW Treasury Government Guarantee Fee Policy for Government Business seeks to ensure competitive neutrality between Government business and the private sector. As a result, a competitive neutrality fee is imposed to ensure neutrality between the allowed regulatory cost of debt and the lower debt issuances that can be obtained from NSW Treasury Corporation.[8] For regulated utilities, the guarantee fee rate is determined using the debt tenor adopted by the regulator's debt allowance benchmark tenor.

Therefore, TransGrid's actual cost of debt would appear lower than the efficient benchmark entity cost of debt with any difference captured by the competitive neutrality fee. On that basis, it is not clear to Origin how TransGrid would be prevented from recovering its actual cost of debt under the transition approach.

In any case, if a business elects not to enter into risk mitigation measures, it is through their own choice that they are prevented from achieving the benchmark. It is a fundamental aspect of incentive regulation that firms should bear the risk and reward of the choices they make, not consumers.

Origin also considers that it is relevant to consider the incentives that exist for TransGrid in pursuing immediate application of the trailing average approach. The timing of the switch to a trailing average approach is an important issue because the debt risk premium rise arising from the GFC temporarily boosted the allowed revenues of the business relative to the costs actually incurred. Therefore, there is an incentive for

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[6] NSW TCorp, The 32nd Annual Report to Parliament of New South Wales Treasury Corporation For the year ended 30 June 2014, p. 18.
[7] NSW TCorp, The 32nd Annual Report to Parliament of New South Wales Treasury Corporation For the year ended 30 June 2014, p.7
[8] NSW Treasury, Government Guarantee Fee Policy for Government Businesses, Policy and Guidelines Paper, May 2014.

TransGrid to switch to a trailing average regime so as to lock-in the accumulated GFC benefit before any reversal can take effect.[9]

In summary, Origin considers that there is insufficient evidence to support the assertion that TransGrid is not being provided with a reasonable opportunity to recover at least efficient financing costs. The onus of proof is on TransGrid to provide actual evidence that demonstrates that its debt financing and competitive neutrality balancing arrangements result in an outcome where transitional arrangements prevent them from reasonably recovering their actual cost of debt. In absence of this case, Origin considers that TransGrid's proposal simply results in a higher WACC, which is not in the long term interests of consumers.

[9] M, Lally, The Trailing Average Cost of Debt, Submission to the QCA, p. 35.