



3 June 2020

General Manager - Distribution
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Email: VIC2021-26@aer.gov.au

Dear Sir/Madam

RE: Submission to Victorian electricity distributors regulatory proposals

Origin Energy (Origin) appreciates the opportunity to provide a response to the regulatory proposals lodged by the Victorian distribution network service providers (DNSPs) with respect to the determination of regulatory revenue allowances for the period 2021 to 2026.

The Covid-19 pandemic is expected to have an unknown, but significant impact on electricity demand and expenditure both within the current regulatory period and potentially extending into the next. Current period revenue will be impacted with the potential for a significant revenue under-recovery. DNSPs and the AER will need to carefully consider how to treat this under-recovery so as not to cause price shocks and further exacerbate any downturn in future demand. This will involve striking a balance between customer impacts and revenue recovery. To the extent that these impacts extend into the 2021-26 regulatory period, we anticipate that the DNSPs' demand and expenditure forecasts will need to be substantially revised.

With respect to the DNSPs' proposals as they currently stand, Origin supports the significant progress the AER and DNSPs have made in driving the Victorian networks towards achieving more efficient expenditure levels. Notwithstanding, the price reductions for the 2021-26 period are largely driven by reductions in WACC and the tax allowance rather than efficient expenditure reductions. We are concerned that, absent these exogenous factors, total revenues would rise under the DNSPs' proposals.

The DNSPs expect significant underspends in both capital (capex) and operating (opex) expenditure during the current regulatory period relative to the AER allowance. We are concerned the original expenditure forecasts may not have been sufficiently challenging, particularly given that network reliability and service quality appear to be unaffected by the underspends. Both capex and opex are now forecast to increase from current levels during the next regulatory period for the majority of DNSPs. It would be disappointing if the next regulatory period were to deliver similar service outcomes as the current period for an increased level of expenditure.

This low actual expenditure also feeds into the AER's efficiency benefit sharing scheme (EBSS) and capital expenditure sharing scheme (CESS). Given the ongoing bias toward the achievement of efficiency payments, we question whether the underpinning expenditure forecasts and embedded efficiency targets are sufficiently challenging.

We note also that a significant contributor to the forecast increase in opex for Jemena relates to the proposed expensing of previously capitalised corporate overheads. While we acknowledge that the proposal is consistent with Jemena's AER approved cost allocation method (CAM) we are concerned that the AER's Cost Allocation Guidelines and the cost allocation principles set out in the National Electricity

Rules (the Rules) have not been appropriately applied in approving Jemena's CAM. Accordingly, we do not support Jemena's proposal to expense all corporate overheads.

The DNSPs identified lower-than-expected demand in the current regulatory period as a contributor to reduced expenditure. Given the current environment it is difficult to see an uplift in demand for this regulatory period. As indicated, the Covid-19 pandemic will have an unknown, but significant impact on electricity demand and future expenditure.

Origin appreciates the DNSPs working cooperatively to align household and small business customer tariffs for the 2021-26 period. Consistency between network areas provides benefits to both customers and retailers easing implementation and customer understanding.

Origin notes the difficulty in locating comparative data in the proposals to allow for stakeholder assessment. We encourage the AER to require each DNSP to provide simple standardised tables displaying, at a minimum, the AER current period allowance, actual/estimated expenditure for the current period and forecast expenditure for the next period, for both capital and operating expenditure by expenditure category.

Origin's response to specific issues identified in the DNSP proposals is set out below.

Capital expenditure

All Victorian DNSPs reported capex underspends in the current regulatory period relative to the AER's allowance. Connections and augmentation expenditure have been impacted by lower-than-expected growth in demand during the period and the DNSPs were also able to defer a number of projects. Despite these underspends, the DNSPs indicated there have been no reductions in service levels or reliability during the period and in fact, it appears that reliability performance has improved across some measures.

With the exception of AusNet Services and Jemena, the levels of capex proposed by the DNSPs for the 2021-26 period represent a significant increase relative to actual expenditure in the current regulatory period. For example, CitiPower's proposal represents an increase of 35 per cent over the actual and expected capex for the current regulatory period. We are concerned that the DNSPs underspent against the AER allowance in the current regulatory period and claim these savings as part of the capex incentive scheme yet request increased expenditure in the next regulatory period. While we appreciate that legislative obligations are responsible for part of the future increase, in the current low-demand environment and with an emphasis on affordability, our expectation is that the RAB per customer would decline rather than continue to increase as is proposed for the majority of DNSPs.

We note that replacement expenditure is the main driver of proposed capex increases for DNSPs. Pole replacement represents a major portion of this expenditure, with substantial increases proposed by CitiPower, Powercor and United Energy. We question the application of an age-based replacement program proposed by these businesses and consider that a condition-based program should be favoured. We also question whether risk assumptions are being appropriately and consistently applied across businesses given the comparatively different approach to pole replacement taken by Jemena and AusNet Services.

We note also that CitiPower, Powercor and United Energy are proposing significant compliance costs associated with meeting environmental protection obligations while AusNet Services and Jemena did not forecast any compliance capex. The disparity in proposed costs associated with meeting these obligations suggests that businesses are potentially interpreting their obligations differently or adopting different risk profiles. We seek a greater understanding of the obligations, the quantum of risks faced by each of the businesses and the process for determining the appropriate compliance solution.

Significant augmentation expenditure is also proposed to accommodate increased residential solar penetration in response to the Victorian Government's Solar Home initiative. Distributed energy resource (DER) integration is an evolving area and the differences in proposals to accommodate increased

penetration across the DNSPs highlights the uncertainty in this area. Origin is supportive of expenditure in this area and, while we appreciate that networks may have different views in response to their individual network constraints, we also acknowledge ongoing work in this area by agencies such as the Australian Renewable Energy Agency and the AER. We encourage an approach that leverages off this work and results in optimising long-term benefits for all network customers not just solar customers.

We are concerned at the persistent high levels of ICT expenditure relative to expenditure over the current period. The DNSPs are proposing ICT expenditure in a range of areas including: cyber security; network management systems; developing “smarter” networks; improving data capture processes; and DER control and management. The customer benefits associated with ICT expenditure can be difficult to quantify and we encourage the AER to closely scrutinise forecast expenditure. It is essential that the AER clarify what is driving the investment, the link between ICT expenditure and increased productivity and efficiency and the benefits to customers. We note also that the business cases for IT projects typically identify the anticipated cost savings resulting from these projects and request that the AER confirm that the identified cost savings have been incorporated into DNSPs’ opex forecasts.

More broadly, we recognise that each of the DNSPs have adopted various asset management approaches to determine their forecast expenditure. Each of these involves assumptions regarding asset condition, asset performance and risk of failure. The AER’s models produce a range of estimates that are driven by different replacement ages and unit cost inputs. For this reason, we consider that the AER has a crucial role in assessing the appropriateness of risk assessment approaches to ensure that they are not overly conservative and that expenditure has been adequately linked to a prudent needs-driven analysis.

We also support the application of both a top-down and bottom-up approach to demonstrate that a level of overall restraint has been brought to bear. This dual exercise is necessary to ensure that forecast costs, including unit rates, have not been overstated and that inter-relationships and synergies between projects or areas of work which are more readily identified at a portfolio level are adequately accounted for.

Demand

Notwithstanding the impact of Covid-19, the DNSPs have overestimated demand for the current regulatory period. For the forthcoming period, all DNSPs are forecasting growth in customer numbers, the circuit length of their networks and in maximum demand. Given changes in utilisation over recent years (solar uptake etc) and recent economic developments we expected demand to remain soft. This view is consistent with the Australian Energy Market Operator’s (AEMO) 2019 Electricity Statement of Opportunities (ESO) which indicates a forecast decline in electricity consumption and maximum demand in Victoria as growth in underlying residential and business load is offset by increasing energy efficiency.¹ AEMO has also factored in the potential for future government energy efficiency schemes during the regulatory period which are yet to be formally announced. The DNSPs’ forecast methodologies appear to differ from the AEMO ESO methodology, particularly with respect to underlying assumption for energy efficiency (including government energy efficiency schemes), maximum demand and weather normalisation. We are unclear on the rationale for these differences and seek further clarification. Given recent economic developments in relation to Covid-19 we expect that a significant reassessment of demand forecasts will be necessary for both the DNSPs and AEMO.

Accelerated depreciation

With the exception of Jemena, all the DNSPs included some form of accelerated depreciation in their proposals, arguing for substantially reduced asset lives for a number of asset categories. Origin is concerned at the proposed quantum of changes in some asset categories. While we appreciate that standard assets lives may not be appropriate for some DNSPs, we note there appears to be a consistent pattern of proposed reduced asset lives over recent regulatory determinations. We question whether the proposal to reduce asset lives reflects genuine changes in actual asset usage or whether it is simply a means of providing DNSPs with increased cashflows at a time of reduced rates of return. We request that

¹ AEMO 2019 Electricity Statement of Opportunities p.106.

the AER critically assess the proposed reduction in asset lives and the recategorisation of assets to confirm that these are appropriate. Given the prevalence of proposed accelerated depreciation there may be a case for the AER to conduct a more widespread review of standard asset lives across the industry or at least provide guidance regarding the circumstances under which significant reductions to asset lives are considered appropriate.

Operating expenditure

All DNSPs anticipate significant opex underspends in the current period relative to the AER's opex allowance. We encourage the AER to review expenditure during the period to confirm that opex underspends reflect sustainable efficiency improvements rather than one-off expenditure reductions. Similarly, it is important for the AER to confirm that opex savings in the current regulatory period are not offset by future opex increases, particularly via step changes and expensing of previously capitalised items. These effectively reset baseline opex and act to negate past savings and thus future consumer benefits. The AER also need to be cognisant of additional baseline opex undermining the effectiveness of the EBSS incentive regime.

We note that Victorian DNSPs are generally regarded as among the most efficient electricity network businesses in Australia, using various efficiency benchmarking techniques. Nevertheless, performance during the current regulatory period suggests the potential for further efficiency gains in the forthcoming regulatory period.

The majority of the DNSPs have adopted 2019 as the efficient base year opex as it represents the most recent actual audited reported performance that will be available before the AER is required to make its Draft Decision. However, AusNet Services and Jemena have proposed 2018 as the base year. We would expect that the base year to be the most recently audited data i.e. 2019. Given Jemena and AusNet Services are deemed to be within the efficiency frontier, we also consider there is scope for the AER to apply firm-specific efficiency adjustments to base opex for these businesses to allow for 'catch-up' to the frontier.

DNSPs are forecasting increases in opex in the 2021-26 regulatory period (relative to estimated actual opex in the current period). These are primarily driven by a number of proposed step change increases, cost reclassifications, increases in input costs and scale escalation and, in the case of Jemena, a change in the treatment of corporate overheads.

DNSPs have proposed a number of step changes in the forthcoming period. These step changes account for over \$280 million of the increase in opex over the forthcoming regulatory period. The main contributors to the proposed increase common to most DNSPs include; 5-minute settlement costs; cybersecurity; insurance premiums; environmental protection issues; IT cloud migration; and solar enablement. We request that the AER confirm:

- that the proposed step changes meet the step change criteria e.g. exogenous;
- compliance requirements associated with step changes are consistently applied;
- risk assessments have been appropriately and consistently applied, particularly with respect to insurance premiums and EPA obligations;
- alternative options to meet legislative obligations have been adequately explored; and
- to the extent that any of these initiatives are postponed (in particular 5-minute settlements) due to Covid-19 that the cost allowances are commensurately reduced.

AusNet Services and Jemena forecast both price and output growth using AER standard approaches. CitiPower, Powercor and United Energy proposed alternative approaches to output and price growth, including the use of independent wage forecast models and the applications of different labour and non-labour weights. While we consider it appropriate for the AER to assess the proposed forecasting methodologies, given current economic conditions, we consider that forecast input costs and output growth may need to be substantially revised for the 2021-26 period.

The AER previously determined a 0.5 per cent per annum opex productivity growth factor for electricity distributors.² All DNSPs appear to have applied the growth factor to opex forecasts for the 2021-26 regulatory period with AusNet Services proposing to double the ongoing cost savings to 1 per cent per annum by absorbing a number of costs.

CitiPower, Powercor and United Energy have been assessed by the AER as amongst the most efficient distribution service providers in the NEM while Jemena and AusNet Services are deemed less efficient.³ While there is clearly room for improvement for both Jemena and AusNet Services, the ability of the Victorian DNSPs to consistently achieve efficiency payments, suggests that efficiencies above those implicit in the AER-approved opex forecasts are achievable. We note that AusNet (\$90.7 million), United Energy (\$72.4 million) and Jemena (\$23.6 million) propose EBSS carryovers in the next regulatory period (see incentive scheme section below).

Jemena Electricity Networks (JEN) - treatment of corporate overheads

Jemena indicated that a proposed change in the treatment of the corporate overheads from 1 January 2021 will add \$62 million to operating expenditure. Jemena suggest that the treatment is consistent with its revised CAM as approved by the AER. Jemena argue that this represents a reallocation of costs, rather than any new costs and that this has not changed the combined total of the capital and operating expenditure forecasts for standard control services.

In its final decision on Jemena's revised cost allocation the AER states that:

JEN submitted that the major reason it was revising its CAM was a change to its accounting practice from 1 January 2021. From this date JEN will expense rather than capitalise all corporate overheads (such as IT). JEN's revised CAM reflects this change in practice.⁴

Origin notes that there is no requirement for regulatory and statutory accounts to align. Regulatory accounts are special purpose accounts prepared in order to provide financial information about the regulated business for use by the regulator, the industry, consumers and other stakeholders. They provide information that is more focused than that contained in statutory accounts as they relate to the regulated businesses or activities.

Further, appropriate cost allocation is a fundamental component of regulatory accounts. Cost allocation should be based on the principle of causation. That is, costs are required to be attributed in accordance with the activities which cause the costs to be incurred. Origin consider that Jemena has failed to demonstrate a causal link between corporate overheads and operating activities. Origin considers it unrealistic to assume that all unallocated corporate overheads are opex in nature – we would expect at least some attribution to capital projects.

The AER provides no analysis of its decision to approve the change to the allocation of Jemena's corporate overheads other than to indicate that the AER determined that the proposed CAM is consistent with the AER Cost Allocation Guidelines (Guidelines). There appears to be no assessment against the cost allocation principles set out in the National Electricity Rules (the Rules). Specifically, the AER indicated that JEN's:

principles and policies to be used for attributing costs directly to, or allocating costs between, categories of distribution services meet the requirements of clause 2.2 of the Guidelines.⁵

Section 2.2.1(b)(2) of the Guidelines indicates that a DNSP must include the following information for shared costs:

² AER 2019, Forecasting productivity growth for electricity distributors – AER Final Decision, March, p.9.

³ AER 2019, Annual Benchmarking Report Electricity distribution network service providers, November, p.iv.

⁴ AER 2019, Jemena Electricity Networks (Vic) Ltd Revised Cost Allocation Method – AER Final Decision, May, p.7.

⁵ Ibid., p.9.

- C. The nature of the allocator, or allocators, to be used for allocating each cost item;*
- D. The reasons for selecting the allocator, or allocators, for each cost item and an explanation of why it is the most appropriate available allocator, or set of allocators, for the cost item;*⁶

It is not clear how the AER have assessed the proposal against the requirements set out in section 2.2 of the Guidelines.

Origin notes that section 6.15.2(3) of the Rules requires costs allocated to a particular category of distribution service to be either:

- costs which are directly attributable to the provision of those services; or
- costs not directly attributable are allocated using an appropriate allocator.⁷

We note that Jemena's approved CAM appears to indicate that an allocator (direct costs) is applied to corporate overheads. Specifically, the CAM states that corporate overhead costs:

...cannot be exclusively linked to specific services, but are necessarily incurred in order for JEN to be able to pipeline services. These costs are captured in cost centres and then allocated on causal basis in proportion to direct costs for each service.

However, the Jemena CAM then goes on to state:

*JEN will expense its corporate overheads for regulatory purposes consistent with changes to its accounting practice from the commencement date.*⁸

The above statements appear contradictory. In the first instance Jemena indicates that corporate overheads will be allocated in proportion to direct cost for each service, but then indicates that corporate overheads will be expensed i.e. not allocated.

The expensing of corporate overheads appears contradictory to the principles of cost allocation and, as previously indicated, alignment with accounting practice is not a sufficient rationale for the proposed treatment. Origin does not accept the expensing of corporate overheads or the rationale provided by Jemena. Origin acknowledges that the AER has approved Jemena's revised CAM and that the proposed expensing of corporate overheads is consistent with the approved CAM.⁹ However, we do not consider it appropriate for the AER to simply indicate that the expensing of corporate overheads is consistent with the approved CAM when the underpinning approval process and its consistency with cost allocation principles set out under the Rules is unclear.

Accordingly, we request that the AER explain in detail how Jemena's CAM and specifically the expensing of corporate overheads to allow consistency with statutory accounting practices meets the AER Guidelines or the cost allocation principles set out in clause 6.15.2 of the Rules. We are concerned that, taken to its logical conclusion and on the basis of the AER's apparent approval process, it is possible that statutory accounts can effectively be presented as regulatory accounts. As stated, regulatory accounts are special purpose accounts and the associated process for cost allocation is clearly set out in the Rules.

Incentive schemes

Given expenditure underspends in the current regulatory period, the DNSPs have applied for efficiency payments in the forthcoming regulatory period via the CESS and EBSS. We have some concerns that the schemes are operating as intended, in particular whether:

- under expenditure during the period reflects genuine efficiency gains and therefore its eligibility under the schemes;

⁶ AER 2008, Electricity distribution network service providers Cost allocation guidelines, June, p.8.

⁷ National Electricity Rules, Chapter 6 Economic Regulation of Distribution Service, pp.816-817.

⁸ Jemena Electricity Networks 2019, Cost Allocation Methodology, March 2019, p.6.

⁹ We note also that the AER have previously approved similar amendments to CAMs for other Victorian DNSPs.

- the robustness of the underpinning AER-approved expenditure forecasts for the DNSPs; and
- the opex efficiency factors applied by the AER are sufficiently challenging.

In regard to the CESS, it is important the AER confirm that the capex underspends in the current regulatory period represent genuine efficiencies rather than over-forecasting or the deferral of capex projects that are then reintroduced in the 2021-26 regulatory period. We find it somewhat counterintuitive that DNSPs can underspend against the AER allowance in the current regulatory period and claim these savings as part of the capex incentive scheme; yet request increased expenditure in the next regulatory period. We request that the AER examine whether proposed capex for the next regulatory period could (or should) have been incurred in the current regulatory period and, if so, whether there was an impediment to doing so e.g. resourcing constraints. We are unclear whether there is an inherent incentive for DNSPs to seek CESS payments rather than top up the existing capex program with future projects, particularly ongoing projects such as the Rapid Earth Fault Current Limiter program.

All DNSPs underspent opex during the current regulatory period and a number of DNSPs are claiming EBSS payments in the 2021-26 period.

Over time we would expect the efficiency payment to tend toward zero i.e. some regulatory periods the DNSPs achieve efficiency targets whilst other they do not. Those networks on the efficiency frontier would presumably have limited scope to achieve efficiencies in excess of the AER's efficiency targets. Similarly, the application of catch-up productivity to those networks inside the efficiency frontier should act to limit the ability of these networks to achieve super-efficiency gains. The ability of Victorian DNSPs, particularly those on the efficiency frontier, to consistently achieve EBSS payments tends to suggest that the incentive regime may not be operating as intended. We consider that either the AER's assessment of DNSPs' opex forecasts is not sufficiently robust and is therefore allowing some "fat" in the forecasts or efficiency targets (including catch-up) are not challenging enough. To the extent this is the case, there will be a bias toward outperformance for the DNSPs and, as a result, future EBSS payments.

Given Jemena and AusNet Services are deemed to be within the efficiency frontier, there is scope for firm-specific efficiency adjustments to base opex to allow for 'catch-up' to the frontier. While we acknowledge that AusNet Services has proposed additional cost savings in excess of the AER's productivity growth factor, we request that the AER identify specific 'catch up' adjustments to both Jemena's and AusNet Services' base opex proposals to move these firms closer to the efficiency frontier.

We note also that the AER's recent Benchmarking Report for DNSPs highlighted that changes and differences in cost allocation and capitalisation methodologies may be impacting the AER's efficiency benchmarking analysis.¹⁰ The AER indicated that it intends to conduct an examination of cost allocation approaches across DNSPs, and their effect on benchmarking. Origin supports such a review.

Tariff structure statements

For household and small business customers consuming less than 40MWh per year, all Victorian electricity distribution businesses have proposed an aligned position:

Origin commends the consistent approach to tariff design proposed by Victorian DNSPs. A consistent approach improves customer understanding and aids in the development of retail tariffs.

Alternative control services

With respect to alternative control services, it appears that the proposed charges for a number of fee-based services have increased considerably between 2020-21 (as set out in the AER approved 2020 Pricing Proposals) and 2021-22. For example, AusNet Services have proposed significant increases for connection services and meter equipment testing both during business hours and after hours. Proposed fee increases for a number of services appear to be well in excess of CPI or wages growth and we encourage the AER

¹⁰ AER 2019, Annual Benchmarking Report Electricity distribution network service providers, November, p.47.

to examine the cost structures associated with these services to determine the validity of the proposed increases.

It appears that DNSPs are also proposing significant increases in labour costs between regulatory periods. For example, Powercor and CitiPower propose increases in “administration” labour rates of over 50 per cent and significant increases in “field worker” labour rates. We note also the substantial variance in “field worker” labour rates between DNSPs e.g. Powercor and Jemena and request further clarification.

It appears also that DNSPs are proposing to consolidate some services in the forthcoming regulatory period. For example, Powercor appear to have consolidated meter accuracy and meter investigation services. We request clarification of any proposed service consolidation between regulatory periods and the associated rationale.

We note also that the fee for failed/wasted field visits for some DNSPs e.g. Powercor, remains the same irrespective of the service being provided. For example, it appears that Powercor’s failed field visit fee for a “special reading” is \$377.90 whereas the fee for a completed special reading is \$50.50. We would expect the failed field visit fee to be the same or less (for example where no materials are used) as the fee for the completed service order.

Powercor, CitiPower and United Energy are proposing significant increases in charges for public lighting services in the first year of the forthcoming regulatory period, for example:

- Powercor - Metal Halide 70 watt (25 per cent increase);
- CitiPower - Mercury Vapour 125 watt (55 per cent increase); and
- United Energy - Sodium High P 100 watt (65 per cent increase).

We request additional information on the proposed price increases.

If you have any questions regarding this submission, please contact Gary Davies in the first instance at

[REDACTED]

Yours sincerely

[REDACTED]

Sean Greenup
Group Manager Regulatory Policy

[REDACTED]