



8 May 2009

Independent Competition and Regulatory Commission
GPO Box 296
CANBERRA ACT 2601

BY EMAIL icrc@act.gov.au

Dear Sir

**DRAFT DECISION: RETAIL PRICES FOR NON-CONTESTABLE ELECTRICITY CUSTOMERS
2009-10**

Origin Energy (Origin) is pleased to respond to the Draft Decision of the Independent Competition and Regulatory Commission (ICRC) for retail prices applying to non-contestable electricity customers in 2009-10.

Origin previously made comments on the Issues Paper and is concerned that the ICRC appears not to have taken account of all the issues raised by Origin and other respondents in its Draft Decision.

Origin supports the removal of price regulation to ensure customers receive the long term benefits of effective competition. However, while retail prices remains regulated for 2009-10, Origin considers the following adjustments in the setting of electricity retail prices are necessary to enhance competition in the Australian Capital Territory (ACT):

- With the proposed introduction of Carbon Pollution Reduction Scheme (CPRS) from 2011, it is important that retail prices reach cost reflective levels and provide adequate retail margins in the preceding periods;
- Recognition that an allowance for customer acquisition costs is a necessary part of a retailer's operating cost and needs to be included in the regulated price in the ACT market;
- That the energy purchase cost used in the determination of regulated retail prices for 2009-10 is indicative of the actual change in wholesale energy cost as purchased by a prudent retailer; and
- Adequate provision of a pass through mechanism when a material change in retailer costs occurs during the determination period.

Origin welcomes the ICRC's views that the removal of price regulation is within the long term best interest of ACT customers and supports the ICRC's suggestion to bring forward the Australian Energy Market Commission (AEMC) review of the competition in ACT from the scheduled 2010 to 2009. However, until that time, Origin is concerned with achieving a functioning market that provides for competition in the short term.

Competition will be stifled if prices remain below cost reflective levels which will be the case if the final decision does not have regard to all issues raised and, in particular, does not adequately take account of price changes between 2008-9 and 2009-10. The comments of the ICRC that the current price determinations undertaken by the ICRC are not sustainable or economically efficient indicate that the ICRC holds similar concerns with regard to long term competitiveness of the market.

Origin makes the following detailed comments regarding the Draft Decision but has commented only on the issues it believes will have the greatest impact upon the retail prices and consequently, future competition.

Methodology

Origin has serious concerns with the application of the adjusted methodology for energy purchase costs and the exclusion of customer acquisition costs from the retail operating costs.

Energy Purchase Costs

Origin is surprised by the large reduction in energy purchase costs between the 2008-9 and 2009-10 periods and believes it does not accurately replicate the change in actual purchase costs experienced by retailers.

It is Origin's understanding from the Draft Decision that the ICRC has correctly applied the methodological change to the tariff index by updating the 2007-08 and 2008-09 figures using its new model, and back solving to produce the 2009-10 index and subsequent retail prices. Origin agrees that this is the appropriate method for dealing with methodological change of an index.

However, Origin disagrees with the ICRC's decision to change the methodology so the assumption of a retailer purchasing peak contracts over two years has been reduced to purchasing over a single year period.

Origin proposes that in reality, no retailer would begin to hedge its required peak load only 12 months prior to the start of the period in question as it would expose it to unnecessary risk as peak is usually the most volatile forward price. For example, a prudent retailer would have started purchasing for 2009-10 in 2007 when contract prices started to rise which is consistent with the previous purchase cost calculation methodology. A prudent retailer's portfolio risk management rules would simply not allow the carrying forward of such a significant proportion of unhedged demand.

Secondly, it has been assumed that 80 per cent of the peak purchases are made in the first half of the 12 months in question. i.e. 80 per cent purchase of peak contracts for 2009-10 are made up June 2008. Although hedging strategies vary considerably depending on circumstances and retailer's risk appetites, Origin would highlight that this is not a realistic scenario albeit it is made in hindsight.

As such, Origin proposes that the ICRC:

- retain the previous methodology with peak contracts purchased over a two year period; and
- spread the peak contract purchases evenly over the period.

The ICRC has pointed to the unreliability of the d-cypha data for peak contracts as the impetus for shortening the period to 12 months but Origin believes there is the opportunity to utilise ICAP data if required, as noted by the ICRC.

Retail Operating Costs

Origin is disappointed the Draft Decision fails to recognise the need to include customer acquisition costs as a legitimate retail operating cost. The ICRC has reached this decision, despite all other NEM jurisdiction regulators accepting and including an allowance for customer acquisition costs where retail prices are regulated.

The ICRC has stated ActewAGL Retail has not provided new information that demonstrates the necessity to include a customer acquisition cost for regulated retail service or the extent to which it incurs such costs. It further states the ACT Government has not amended the Terms of Reference to specify the ICRC is to take account of customer acquisition costs.

An incumbent may have no need to incur customer acquisition costs if customers are returning without being offered or seeking market contracts. The ICRC recognises the Transitional Franchise Tariff (TFT) should not be considered as the price that a competitive retailer sets in the market. However, if this is the case, the incumbent retailer should be actively seeking to retain customers and offering market contracts. The absence of such conduct suggests competition is not effective and the incumbent may exhibit characteristics of a monopoly supplier. In short, if the TFT is set at the lowest possible price for the incumbent without providing for recovery of retention or acquisition costs then a new entrant retailer may not be able to compete and can certainly not offer discounts to a TFT that does not contemplate all legitimate retail operating costs.

Origin has had considerable experience with the costs and risks facing a retailer entering a new market and in managing the subsequent business processes associated with customer churn and competition generally. If these costs are not recognised in some form by the pricing regulator when setting standard prices, then it is hardly surprising if competition fails to either occur or be sustained. The regulator has only to look at the trends in competition rates in NSW, Queensland even SA compared to Victoria (where price regulation has been removed) to reinforce the impact of regulatory pricing decisions that do not reflect a retailer's costs to supply. Retailers have demonstrated a clear willingness to retreat from markets (or simply not enter markets) in these circumstances, leaving customers to fall back on to standard contracts.

Origin also believes that an allowance for customer acquisition has been improperly characterised by the ICRC as additional headroom. Put simply, retail tariffs will be cost reflective if they allow full recovery of input costs, retail operating costs and an appropriate margin. The absence of such an allowance means retail tariffs may never be truly cost reflective as recognised by the AEMC' in its review of retail competition in South Australia:

"If standing contract prices do not include customer acquisition costs then there is a risk that the prices could foreclose retail competition because, unlike the assumption made regarding the standing contract retailer, new entrant retailers will need to recover the efficient costs of customer acquisition in the prices they

charge under market contracts. Care must therefore be exercised when considering customer acquisition costs.”¹

The ACT electricity retail market exhibits limited marketing activity and the churn rates significantly lag behind those of other States despite full retail competition being in place for similar or lesser periods. Origin accepts it may be difficult to draw absolute conclusions that the regulated price is set too low based only on low churn rates and a reduction of market contracts as such behaviours may have multiple explanations or possible contributing factors. Having said this, it is difficult to assume the retail price is not inhibiting market offers and thereby conclude with confidence the retail market is functioning properly.

Origin notes the ICRC seeks direction from the ACT Government to permit an allowance for customer acquisition costs. Origin does not believe the terms of reference preclude the inclusion of customer acquisition costs, and in fact, the terms of reference requires the ICRC take account of matters set out in Section 20 of the Act². Specifically ss20(1)(d) and (e) state, in making the decision the ICRC must have regard to an appropriate rate of return on any investment in the regulated Industry, and the cost of providing the regulated services, respectively. Therefore, it is Origin’s opinion that the ICRC has an opportunity to include an allowance as part of retail operating costs.

Additionally, S.20 of the Act does not seek to balance potential competing factors thus there is no suggestion that social impacts or other considerations should outweigh retailers’ risks that are associated with retail prices below cost reflective levels. Accordingly, there appears to be no reason for the ICRC to deny an allowance for customer acquisition costs.

Competition Review

Origin agrees with the ICRC that the removal of price regulation is in the best long-term interests of all consumers. However, the ICRC states it is not blind to the potential problems that might occur in the transition to a fully deregulated competitive market. Origin sympathises with the sentiment of the ICRC, however the present approach of the ICRC denies the ACT retail market the transitional phase which is necessary for competition to succeed, that is, providing for a cost reflective price to enable new retailers to establish market position before innovation and vigorous competition emerges. As the name of the TFR implies, it is a transitional retail tariff, providing a cap on market prices whilst competition is propagated.

Origin has concerns that where the retail tariff is not cost reflective and is inhibiting competition, the consequent damage upon competition may be self-perpetuating and will require further significant interference to rectify the issue.

A prerequisite for removal of price regulation, according to the terms of the Australian Energy Market Agreement (AEMA), is a functioning competitive market. In its absence, price regulation may continue post the AEMC review in the ACT which may impede the long term interests of consumers further into the future.

¹ Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia - First Final Report, p182, Australian Energy Market Commission (2008)

² Section 20(1), *Independent Competition and Regulatory Commission Act 1997* (Act) - Directions about Prices

Pass-through Arrangements

Origin supports a general pass-through mechanism similar to that put forward by TRUenergy in its submission to the Issues Paper. That is, a pass-through event will be triggered where there is a material change in a retailer's cost base relative to the assumptions made in the price path determination. .

With the uncertainties surrounding the introduction of CPRS, there is the potential for extreme volatility in the wholesale energy market that has not been appropriately incorporated within the Draft Decision. Accordingly, Origin does not believe the proposed 3.84 per cent price increase is a true representation of the underlying cost increases for 2009-10 and believes a cost pass-through mechanism is warranted.

Origin would reiterate that it fully supports the ICRC's aim to move towards the removal of price regulation however, it is imperative that the correct foundations of cost reflectivity are in put in place prior to deregulation.

Should you require further information regarding these issues, please do not hesitate to contact Patrick Whish-Wilson on (07) 3867 0620.

Yours sincerely



Duncan Permezel
Retail Executive Directions & Growth

