



28 March 2014

Malcolm Gray  
Senior Commissioner  
Independent Competition and Regulatory Commission  
PO Box 161  
Civic Square ACT 2608  
Dear Senior Commissioner

[lodged by email]

Dear Senior Commissioner

**RE: RETAIL PRICES FOR FRANCHISE ELECTRICITY CUSTOMERS FROM 1 JULY 2014, DRAFT DECISION**

Origin appreciates the opportunity to comment on the Independent Competition and Regulatory Commission's (ICRC) Draft decision on setting retail electricity prices in the Australian Capital Territory for the year beginning 1 July 2014.

As outlined in our response to the Issues Paper we are concerned that the ICRC's approach materially understates the cost to retailers of servicing retail customers, with negative impacts on competition and to the long term detriment of its electricity customers. This is despite effective competition being a key objective of the ICRC<sup>1</sup> and the removal of price regulation being agreed as an objective of the Council of Australian Governments<sup>2</sup>.

In our view the ICRC's decision not to include an allowance for customer acquisition and retention costs and to reference only market-based costs in the wholesale energy allowance have put progress towards greater competition and price deregulation on hold, a decision explicitly acknowledged by the ICRC in its extensive analysis questioning the benefits of competition in retail electricity markets. We are concerned that the ICRC may have departed from its legislated role to promote effective competition, undertaking a theoretical analysis of whether greater retail competition is *prima facie* desirable and using this as a basis for rejecting a customer acquisition allowance.

Wholesale energy cost

Origin opposes the ICRC's draft decision to reference only market-based prices when setting the wholesale energy cost allowance. Instead, Origin supports the ICRC using a blend of long run marginal cost (LRMC) and market based prices. We note the arguments identified by the ICRC as reasons for opposing an LRMC component and address these below.

Firstly, the ICRC finds that in a competitive market retailers would be obliged to price at short-run marginal cost, in the event this fell below long run marginal cost, and that regulator's

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<sup>1</sup> Independent Competition and Regulatory Commission Act (1997), s.7(a)

<sup>2</sup> COAG Energy Reform Implementation Plan, 7 December 2012

pricing decisions should seek to approximate competitive conditions. We find it likely that even retailers that do not own generation assets rely on a mixture of shorter and longer term arrangements when procuring energy for retail customers, rather than relying solely on derivative instruments linked to changes in the spot price. Derivative instruments that closely track spot prices are unlikely to be adequate protection from medium term changes in market dynamics. This explains why in jurisdictions where regulated prices have not included a reference to LRMC (or some other offsetting element) competition has fallen away; because retailers will avoid competing for customers at levels that are consistently below their average cost. The logical corollary of the ICRC's premise is that non-vertically-integrated competitors should already have sought to acquire customers in the ACT market, based on their lower cost base; yet there is very limited evidence of this.

Origin notes the ICRC's second finding, namely that there is no settled methodology for estimating LRMC. Origin questions this conclusion. While there may not be one unique agreed methodology, there are a small number of approaches that are commonly used and theoretically defensible, and investors in generation rely on such models when making large and long term investments. There is equally no single approach to estimating retail margin for regulatory purposes yet this does not preclude regulators from identifying and adopting acceptable approaches. Origin contends that approaches to estimating LRMC exist upon which the ICRC could reasonably rely.

Thirdly, the ICRC determines that while there may be a level of market failure in the electricity market (with the market providing insufficient incentives for investment in wholesale generation) it is not the role of the regulator to seek to resolve this. In this context the ICRC refers to findings from its earlier paper on wholesale energy cost approaches<sup>3</sup>, which examined the potential for market failure in the NEM, on the basis that average returns may not have justified timely commercial greenfield investment in base load generation. We note that:

- Power purchase agreements (PPAs) have been crucial in underwriting investment in generation across the NEM, and
- the current calibration of the Renewable Energy Target (RET) is bringing more wind into the market than is required and so is depressing prices artificially.

We acknowledge that it is not the role of the ICRC to seek to address shortcomings in the market and policy framework. However, we would note that it is the role of the regulator to consider market dynamics and how these inform spot prices, particularly when relying heavily on spot prices (and associated derivatives) to set a wholesale energy allowance. The current spot price does not reflect the commercial arrangements that support the bulk of supply in the wholesale energy market, due to the prevalence of PPAs and the impact of the RET. While additional generation capacity may not currently be required, a more pressing implication of the ICRC's approach is that in understating the average cost retailers face to procure electricity, the regulator ensures competition will not develop further in the retail market. In our view this should be of primary concern to the pricing regulator.

The ICRC expresses concern that the LRMC might at times be higher than the costs retailers incur in meeting the wholesale load and that this would mean customers paying more than actual cost. Yet the ICRC expresses no equivalent concern about the implications of market-based costs being lower than the average cost of supplying load. The risks attending these outcomes are asymmetric in Origin's view. If the energy allowance is marginally higher than the average cost retailers incur this will encourage entry by smaller retailers to bid down this margin. To the extent the allowance understates average cost this will inhibit competition leaving customers worse off in the long term. Origin reiterates that the ICRC is not obliged to rely exclusively on one approach, but could instead reference LRMC through a blended approach, recognising the different approaches employed by market participants.

#### *LRET costs*

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<sup>3</sup> ICRC, Final Technical Paper, Model for Determining Energy Purchase Cost Component of the Transitional Franchise Tariff, 2010

Origin has argued that ICRC should reference the long-run marginal cost of generating renewable energy when estimating the cost to retailers of meeting the LRET, since retailers do not rely exclusively on market purchases of Large scale Generation Certificates (LGCs) in order to meet their LRET commitments. In addition to market purchases, they invest directly in plant and long term power purchase agreements.

Origin notes that growing uncertainty about the future of the scheme in recent months has led to dramatically shallower markets for LGCs. The issue has become more pronounced since the Federal Government announced the details of panel that will undertake the RET Review. Policy uncertainty around the LRET is particularly acute, with a broad spectrum of outcomes possible, from the removal of the carbon price and no change to the LRET target, which would lead to an increase the cost of the LGCs (all other things being equal), through to the dismantling of the scheme in its entirety (which is yet to be ruled out by policymakers). Each outcome within this spectrum has different implications for the value of LGCs, which is leading both buyers and sellers to hold off to await the outcome of the RET policy review.

In this environment liquidity and depth in the LGC market are significantly constrained and prices in that market are no longer representative of reasonable assessments of the cost of meeting the LRET target. IPART reached a similar conclusion in its review of electricity prices for 2013-14. In light of this Origin believes a more reliable approach would be for the ICRC to adopt the LRCM of large scale renewable generation.

#### *Pass through of carbon*

Origin supports the ICRC including a carbon component subject to an intra-year pass through of carbon costs, with carbon costs based on the legislated carbon price, which is added to AFMA carbon-exclusive contract costs.

#### *Retail cost allowances*

Origin welcomes the decision to increase the retail operating cost allowance and the retail margin, bringing both more into line in line with allowances in other regulated jurisdictions.

These positive improvements have a limited positive impact, however, due to the ICRC's decision not to include an allowance for customer acquisition and retention. Origin finds it particularly concerning that the ICRC has chosen to re-examine at some length the *prima facie* case for competition in retail electricity markets, rather than focussing on the case for how best to foster greater competition in light of the existence of regulated prices.

As noted above (and by the ICRC) the goal of encouraging competition is the first principle listed in the ICRC's enabling legislation. Origin acknowledges that the ACT Government's expressed preference for the ICRC not to seek to foster greater competition through the inclusion of a CARC allowance may lead the ICRC to feel constrained in its decision-making, although we question whether this preference should prevail over the tenets of the ICRC's enabling legislation.

However, we would highlight that by re-opening debates about the benefits of competition in retail electricity markets and by positing a special status for retail electricity markets with respect to the benefits of competition in markets generally, the ICRC runs counter to over a decade of concerted reform in the energy sector, championed by successive Federal and state governments across Australia and agreed by the Council of Australia Governments in the Australia Energy Market Agreement. This conclusion is also inimical to findings of the independent body primarily tasked with examining the drivers of efficiency and micro-economic reform in the Australian economy, the Productivity Commission, which found with respect to energy markets:

*Consistent with commitments in the Australian Energy Market Agreement (AEMA), retail price regulation should be abolished by state and territory governments as soon as effective competition has been demonstrated. Allowing more cost reflective tariffs would improve*

*incentives for new investment and the incentive for consumers to use energy commensurate with its economic cost.*<sup>4</sup>

We reject the notion put forward in the ICRC's analysis that the electricity market has special characteristics whereby prices set by regulators will be more efficient than prices set under effective competition. We acknowledge that no approach to price discovery is perfect, but maintain that regulated pricing in an environment of negligible competition is a model replete with cost and risk. We also reject the notion that because prices are lower in the ACT than some prices in deregulated jurisdictions that ACT residents are benefiting from an efficient price or that the current pricing model is sustainable over the medium term. In this context it is notable that the ICRC does not appear to address the notion of efficient consumption decisions and the importance of cost reflective prices in enabling these.

In summary, Origin is concerned that the ICRC's position appears to represent a significant departure from a long established direction of reform. While we do not reiterate here all the arguments that in our view strongly mitigate the imperfections of competitive markets, we highlight that these mitigating factors are not adequately examined in the ICRC's analysis. We strongly urge the ICRC to consider its findings in light of the findings of the Australian Energy Market Commission, the Productivity Commission and the consolidated view the Council of Australian Governments with respect to competition in retail electricity.

If you have any questions regarding this submission please contact me in the first instance on (02) 9503 5674.

Yours sincerely,

[SIGNED]

Keith Robertson  
Manager, Regulatory Policy

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<sup>4</sup> Productivity Commission, Annual Review of Regulatory Burdens on Business: Social and Economic Infrastructure Services, Research Report, p.xxxi