13 February 2012

Independent Competition and Regulatory Commission
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BY EMAIL icrc@act.gov.au

Dear Sirs

ISSUES PAPER:
RETAIL PRICES FOR NON-CONTESTABLE ELECTRICITY CUSTOMERS 2012-14

Origin Energy (Origin) is pleased to take this opportunity to comment on the Independent Competition and Regulatory Commission's (ICRC) *Issues Paper: Retail Prices for non-contestable electricity customers – 2012-14.*

Origin welcomes the review of retail prices and further consideration of issues that have in the past been contentious in price reviews in the Australian Capital Territory (ACT). The pricing reviews in the ACT are uniquely different to the paths chosen by other Australian jurisdictional regulators and have disregarded the relationship between the LRMC of electricity generation and the energy purchasing costs of retailer's. Additionally, the ICRC has previously denied customer acquisition costs as a legitimate sales and marketing cost for competing businesses. These decisions have been at the cost of a competitive retail market.

Although the ICRC is predisposed to retaining the methodology used to determine the retail electricity tariffs for 2010-12, it is cognisant of changes in the energy market that will impact upon retail prices for 2012-14 and has requested stakeholder comments on:

1. The current regulatory approach whereby the ICRC bases cost components on the efficient costs of the incumbent retailer;
2. The impact of carbon pricing on the energy purchase model; and
3. any individual cost components.

Regulatory Approach

The Australian Energy Market Commission (AEMC) proposed in its review of the effectiveness of competition in the ACT (2011) that an option for increasing competition was for the ICRC to base the regulated retail tariffs on the efficient costs of a new entrant business. Consequently, the ICRC has posed the question whether the benchmark cost components should be based on a hypothetical new entrant electricity retailer instead of the current method of identifying the efficient costs of the incumbent retailer. The ICRC believes there is a compelling economic basis for maintaining the model based on the efficient costs of the incumbent retailer.

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Origin welcomes the decision of the ICRC to revisit the inclusion of CARC. Origin has previously disputed the approach of the ICRC to exclude an allowance for the recovery of CARC. Origin considers the ICRC's stance is based on an erroneous view that an incumbent firm and new entrants face the same set of cost drivers except for the costs of attracting customers. This observation may be true in an immature market in which the incumbent firm does not need to actively compete. However, as competition increases the incumbent must ramp up its acquisition and retention budget otherwise it risks losing a substantial share of the market. Accordingly, the incumbent's costs may be lower where it is not actively seeking to retain customers and offering market contracts, such as when competition is restrained by non-market based regulated pricing outcomes (as is the current state of the market) but will rise incrementally as customer transfers increase and competition takes hold.

Origin supports a regulatory approach that is the most consistent with the development of retail contestability. Competitive markets have responded better where costs are based on a new entrant cost scenario. Evidence from other jurisdictions clearly demonstrates that the inclusion of customer acquisition and retention costs (CARC) is necessary for the functioning of a competitive market and the ACT market is not immune from this reality.

ESCOSA based the South Australian electricity retail costs on a benchmark approach (although actual incumbent cost data was obtained to determine the sensibility of the benchmark), and stated in its recent electricity price determination:

> *"ROC allowance is set by having reference to the entire retail market, rather being based on the costs incurred specifically by AGL South Australia…the ROC allowance represents the costs that a new entrant would be expected to incur in meeting the responsibilities of standing contract supply to small customers in South Australia"*

An incumbent should be actively seeking to retain customers and offering market contracts to its contestable customers. In circumstances where the incumbent is not exhibiting these behaviours it indicates new entrant behaviour is constrained. Origin submits if the ICRC derives its cost components based on regulatory benchmarks then it must reconsider this issue as the ACT remains the only jurisdiction not recognising CARC in its regulated price.

Cost Components

ICRC previously estimated the individual cost components of the retail price by drawing from benchmark cost information available in the marketplace and in other regulatory decisions. Origin supports such an approach provided proper account is taken of the differences in the electricity market and jurisdictional regulatory approach when adopting the benchmarks. Specific concerns with the ICRC approach are outlined within the discussion directed at each cost component.

Electricity purchase costs

The ICRC has chosen to continue with the methodology for determining the electricity purchase costs developed for the electricity prices in the 2010-12 determination. Origin considers there are specific flaws in the wholesale energy purchase cost model that must be addressed:

- The ICRC wholesale energy cost (WEC) model calculates the cost of the load shape as the ratio between the load weighted (volume) and time weighted spot prices. This ratio is then applied to the base load (flat) contract price for future years and formulates an estimate of load shape cost. This methodology averages the past pool price/load relationships and the load weighting derived reflects little of the load and price risks the retailer faces in the coming year. It implies that a retailer hedges to the average load weighted price whereas a prudent retailer hedges to more extreme price outcomes;
- The WEC model is an artificial method for determining the electricity purchase costs of a retailer that does not reflect the purchasing behaviour of a prudent retailer. It assumes a retailer can hedge its entire load at the forward flat price adjusted for historical load weighted price. Although this method is an attempt to model the cost of hedging a small customer load shape in the ACT, it is not a realistic analysis of a true market method;
- The model simulates a range of historical prices but not all possible price outcomes; therefore it leaves a retailer potentially exposed to high pool prices at times of peak demand. A prudent retailer utilises caps to cover this exposure, however the model takes no account of such a strategy and therefore does not recognise this as a legitimate wholesale energy cost; and
- A common criticism of regulatory methodologies establishing an energy purchase cost allowance is the failure to recognise the risks in the wholesale energy market and the strategy used by retailers to mitigate these risks. Regulators are yet to fully appreciate the costs involved in running an energy portfolio and continue to undervalue or ignore the reality of energy trading risks.

For the reasons listed above, Origin does not support the current model as representative of retailer costs. It grossly underestimates the costs and risks of retailers and as a consequence, is not appropriate for the derivation of retail prices.

Origin advocates a market based approach for determining electricity purchase costs that also adjusts for risk. Since market prices show volatility over time, it is fundamental that LRMC of generation sets the floor for all existing retail energy markets subject to price regulation. Using LRMC as a reference cost is most apt for situations where the trading market is shallow or if there are market uncertainties and risks such as those introduced by legislative change (e.g. carbon price).

On the issue of risk, Origin is pleased to note the Terms of Reference requires the ICRC to investigate:

> "*the efficient and prudent cost of managing risk in the cost of purchasing electricity.*"

To reflect the risks faced by a retailer, the model might be improved by making an allowance for volume and extreme event risk to cover the cost of products used by retailers to manage this risk exposure. The cost to a retailer for cap contracts and other risk products can be as high as an additional $15/MWh to the model result. A risk allowance will bring the modelled wholesale energy costs more in line with a retailer's true cost.

Carbon pricing

The ICRC notes the most significant development the model has to deal with is the introduction of a carbon price from 1 July 2012. Origin believes the carbon price will have a material impact upon the underlying concept of the ICRC model.

The ICRC approach uses the load weighted and time weighted spot prices to establish a load shape and determine a load weighted average price ratio. The model relies on actual contract prices published by d-Cypha and historical pool prices; it assumes that the load weighted price of the past regulated load is reflective of the future load weighted price. It also assumes that the carbon inclusive load weighted price will not differ from the past non-carbon load weighted price even though it is believed that carbon will affect peak and off-peak prices in different ways.

The inclusion of a carbon price in forward prices will render the historic relationship between time weighted and load weighted prices irrelevant. Consequently, the basic premise upon which the ICRC model relies falls away with carbon inclusive forward prices. Origin believes that using the ICRC simple approach will result in unrealistic and undervalued wholesale cost outcomes.

Furthermore, the modelling of carbon inclusive prices within the energy purchase costs will result in skewed wholesale outcomes for a retailer. Although forward contract prices are starting to reflect carbon, the full impact of the carbon price upon wholesale prices has not yet been realised. Origin believes the legislated carbon price is an input cost for electricity generation from July 2012 and as such should be treated as a cost pass-through. The broad expectation of the market will be the $23/tonne CO_2-e tax will be passed through the energy price at the market carbon intensity.

Accordingly, Origin supports a separate pass-through of carbon instead of a modelled carbon inclusive energy purchase cost allowance. It is noteworthy that a small margin for error will equate to a material risk for retailers; a risk that cannot be hedged.

Green costs

The ICRC plans to continue with its approach taken in the 2011-12 price reset and have green costs based on actual costs of ActewAGL although using market-based costs whenever possible. In terms of the appropriate calculation for green costs, the actual costs of ActewAGL and the costs of a new entrant should be consistent. Regardless of the costs adopted, Origin supports the transparent disclosure and calculation of any green costs which has in previous years not been available for stakeholder scrutiny.

The 2011-12 green costs (excluding pass-through costs) determined by the ICRC was $10.29/MWh which was similar to the NSW IPART determination and consistent with market expectations. Origin is supportive of a similar approach for the new determination although, again, greater transparency in the calculations is required.

It is also important to note that there will be an under-recovery for the cost of the small-scale renewable energy scheme (SRES) in the 2011-12 tariff prices. This shortfall of SRES costs should be embedded in the 2012-13 price as a cost pass through.

Retail Margin

It is noted that the ICRC believes a 5.4 per cent margin is sufficient and aligns with other regulatory benchmarks specifically referring to the NSW regulatory decision. Origin strongly believes a higher margin is appropriate for certain regulatory frameworks. Unlike the ACT, the NSW retail pricing determination provides greater certainty and mitigation of wholesale risk by using the LRMC of generation as the floor for wholesale energy costs.

Markets that rely on artificial market based models add further uncertainty and greater risk for second tier retailers. These risks are further amplified by the carbon uncertainty in 2012-13. Accordingly, Origin believes the margin of 5.4 per cent should be escalated to take into account the differences in wholesale risk unless the ICRC applies an appropriate wholesale risk premium to the energy cost allowance.

Cost pass-through

Origin supports a cost pass-through mechanism that allows for unexpected cost changes that meet a materiality threshold, as currently in place in the 2010-12 determination. In 2011 there were significant changes to the renewable energy scheme that precipitated a cost pass-through event. If the cost pass-through mechanism were not available in the 2010-12 determination then retailers would have had no choice but to absorb the costs associated with the legislative change implemented midway through the determination.

A retailer should not be forced to carry the risk or cost associated with the introduction or a change to Government policy or legislative change and indeed such a position is untenable. Accordingly, there must be an opportunity for cost recovery for unexpected events in future determinations in line with the current pricing determination. Such a mechanism will cover the risk associated with the introduction of an ACT Government's energy efficiency scheme[1] if unable to be quantified before the final determination or other unanticipated regulatory change.

In the event an effective cost pass-through arrangement were excluded from the determination this would necessitate an escalated margin rate to take account of the framework differences to the NSW determination that provides for an annual review mechanism and cost pass through.

Should you require further information regarding these issues, please do not hesitate contact me.

Yours sincerely

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Regulatory Pricing Manager

[1] See *ACT Sustainable Energy Policy*