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1. **INTRODUCTION**

Origin Energy ("Origin") welcomes this opportunity to comment on the draft determination of NSW Electricity Distribution Pricing 2004/05 to 2008/09.

Origin is a national integrated energy business with 140 years experience in the Australian energy sector. Origin has over two million customers in Australia, New Zealand and the Pacific, and interests in gas and electricity retailing, gas-fired electricity generation, cogeneration projects, LPG supply, gas-transmission pipeline development and exploration. Origin is an active participant in competitive gas and electricity markets.

With the introduction of full retail contestability, Origin seeks to enter and participate in markets that are transparent, offer the opportunity to earn a reasonable rate of return, and provide a level playing field for all market participants. Origin has not entered into the general mass market for gas and electricity in NSW, even though FRC was introduced more than 2 years ago, due to a lack of retail margin. Origin believes current regulated retail margins in these markets are insufficient for the effective functioning of competitive broad based mass markets in electricity and gas.

2. **GENERAL COMMENTS**

Origin’s prime concern with current regulatory arrangements for NSW distribution services relates to ineffective ring-fencing arrangements and the deleterious impact this has on retail competition, and ultimately, benefits available to NSW energy consumers. Specifically, Origin is concerned with the appropriateness of current cost allocation approaches and the effectiveness of existing accounting separation requirements placed on NSW state-owned electricity businesses (encompassing both distribution and retailing).

Inadequate information disclosure, the result of poor accounting separation requirements, tilts the playing field against new entrant retailers. For example, there are wide discrepancies between the reported operating costs of local distributors, local retailers, NSW Treasury and the Productivity Commission. In particular the retail cost to serve estimates appear to be too low and the cost allocation is heavily weighted toward the distribution part of the business (versus retail part) in reporting by some DNSPs. Origin’s commercial assessment of NSW energy retail businesses shows that actual operating costs for NSW retail operations are significantly higher than those reported by the businesses and published by the Tribunal.

The Minister for Energy and Utilities has said that ‘if regulated retail tariffs do not adequately reflect all of the costs of supply to small retail customers, both those customers and prospective competing retailers have little incentive to enter the competitive market.’ Origin strongly endorses this statement and believes that the

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current retail cost benchmarks used in regulated retail tariffs should reflect actual costs to encourage competition in a broad based mass market.

Further comments on the draft determination are to be found in the following sections of this submission.

3. REGULATORY FRAMEWORK

Origin is satisfied with the general approach adopted by the Tribunal for prescribed distribution services. This includes using the weighted average price cap method supported by the building block approach to regulate DUOS tariffs, pricing principles to set network tariffs, annual price information disclosure and public consultation.

3.1 Length of the regulatory period

Origin strongly advocates a “light-handed” approach to regulation. Notwithstanding this, Origin supports the Tribunal’s decision for a five year regulatory period for distribution price review. Origin agrees with the Tribunal that a regulatory control period of five years would strike a balance between reducing regulatory uncertainty and providing a predictable environment to allow for the effects of the proposed changes to filter through to the consumers.

4. THE COST BUILDING BLOCKS

4.1 Growth assumptions

Origin has no issues with the Tribunal adopting the MMA’s growth forecasts. However Origin has an issue with the Tribunal using the DNSPs’ forecast costs as proposed in the Draft Determination. Origin also notes the Tribunal’s invitation to DNSPs to submit any projected additional costs they may incur as a result of the higher forecasts. Origin is particularly concerned with how the Tribunal will determine if the costs associated with those forecasts are efficient and that shared costs or the costs associated with any shared services have been correctly allocated between the distribution and retail part of the business.

4.2 Efficient capital, operating and maintenance expenditure

In general Origin is not satisfied with the Meritec report in that it is unsubstantiated and highly contentious in its assumptions and approaches. Origin is concerned about allocation issues and the fact that Meritec did not seek advice from experienced industry stakeholders such as Origin and failed to disclose the cost benchmarks used in determining the efficient expenditure. Origin believes that there is a lack of information disclosure on the benchmark used for DNSPs’ capital and operating expenditure in the Meritec report. Origin also has serious concerns with the terms of reference for the Meritec report in that it only addresses the issue of prudence and not efficiency in reviewing DNSPs’ past capital and operating expenditure. Expenditure which might be technically prudent might not necessarily meet the cost benefit test under the National Electricity Code.

4.3 The opening regulatory asset base for 2004/05
Origin contends that the rolling forward of the 1998 regulatory asset base to 30 June 2003 should be on the basis of prudent and efficient capital expenditure.

Origin further believes that the appropriate approach for the valuation of the 1998 regulatory asset base should be historical cost without indexation. The view that indexation is not appropriate in determining the value of the regulatory asset base is based upon features of the application of the WACC in price regulation. Specifically, WACC parameters include adjustments for CPI and therefore applying CPI to the historical cost of the asset and including this value in the regulatory asset base artificially inflates the asset values (partially double counting the effect of inflation).

4.4 Return on capital

Network assets are generally capital intensive and have long life by nature. An investor in network assets needs to be convinced that the investment will deliver a return high enough to meet his risk adjusted hurdle rate. Inadequate returns are harmful for investment in the industry. Origin therefore supports a rate of return commensurate with prevailing market conditions and the risks involved.

Origin is satisfied with the Weighted Average Cost of Capital approach to determine the rate of return. However Origin believes that the debt margin used by the Tribunal is too high for a state-owned business where the parent (the NSW Government) having a ‘AAA’ credit rating.

4.5 Return of capital (depreciation)

Origin is satisfied with the method used for depreciation. However Origin wishes to stress that the method for depreciating the regulatory asset base should be applied consistently, transparently and uniformly across all DNSPs. Regardless of the depreciation method used, regulated retail prices should reflect the full impact of depreciation charges, which are ultimately passed through to end-use consumers.

4.6 Working capital

Origin is not satisfied that the Tribunal uses 45 receivables days to calculate the working capital for DNSPs. origin believes that almost 100% of a DNSP’s customer is the retailer (not the end-use consumers) and therefore, on a business to business basis, the same number of days should be expected for receivables as for payables. If a ring-fenced DNSP operates at arms length with its retail business, then this should be expected from the DNSP as it applies to other retailers. This is an example of the type of cost allocation issues referred to previously.

4.7 Treatment of the 1999 determination’s outstanding unders and overs account balance

Not withstanding Origin’s view that the over-recovery of network charges should be returned to customers in the manner intended in Rule 2001/3, Origin’s preferred approach is for the over-recovery to be deducted from the revenue requirement in 2004/05 to limit the extent of a large price increase at the start of the next regulatory period.
5. **CALCULATING THE AMOUNT BY WHICH AVERAGE DISTRIBUTION PRICES CAN CHANGE**

Origin is not opposed to the x-factors and revenue approaches proposed for the 2004-09 regulatory period. However, any changes in network prices should be reflected in the retail prices in order to provide effective signalling of the economic costs of energy use to consumers (and therefore to encourage efficient outcomes).

Furthermore, Origin contends that the pass through of network price changes should be managed under transparent ring-fencing rules to ensure a level playing field for all prospective retailers seeking to compete in the NSW electricity market. Additionally changes to tariffs must be done in consultation with retailers, and there must be ample time given to retailers to make necessary adjustments to retail tariffs and for implementation of these adjustments.

Origin notes that the Tribunal is not inclined, at this stage, to implement an efficiency carry-over mechanism for the 2004-09 regulatory period, as it is not clear to the Tribunal that the benefits to be gained from such a measure outweigh the costs and the practical difficulties associated with their implementation. Origin does not have an issue with the approach taken by the Tribunal. To this end, Origin urges the Tribunal to engage all participating retailers when working on the design of the efficiency mechanism and to allow ample time for implementation to ensure effectiveness and practicality.

6. **PROVIDING INCENTIVES FOR SERVICE QUALITY**

Origin is supportive of the incorporation of a service quality incentive mechanism in the price control formula. However, Origin strongly believes that any changes in network prices must be reflected in the retail prices in order to provide effective signalling of the economic costs of energy use to consumers; and the pass through of network price changes should be managed under transparent ring-fencing rules to ensure the a level playing field exists for all prospective retailers seeking to compete in the NSW electricity market. Based on Origin’s experience, the incorporation of a service quality incentive mechanism in the price control formula may introduce an element of volatility into the price setting process.

7. **PROVIDING INCENTIVES FOR DEMAND MANAGEMENT**

Origin welcomes the Tribunal’s intention to introduce demand management. Origin notes that the Tribunal acknowledges the following in its proposed treatment of demand management:

- demand management also requires action by retailers and customers;
- individual contracts with end-users, possibly including performance criteria, would be classified as demand management under the current framework.

However Origin is unclear on the following issues and seeks the Tribunal’s resolutions for those:

- there is not a clear definition of what constitute demand management;
- there is no incentive for end-use consumers to adopt demand management;
- there is no incentive for retailers to implement demand management;
- there is no consideration given, and explanation on how, demand management costs will be recovered if implemented by retailers;

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Origin is firmly of the opinion that demand management is as much an issue for retailers as for DNSPs. Origin therefore believes that where demand management is an initiative of a retailer, for example when a retailer negotiates an individual contract with the end user, then the retailer should be entitled to pass through the implementation costs up to the amount of avoided distribution costs to the DNSP. That is the DNSP will refund the demand management implementation costs incurred by the retailer using the saving from avoided distribution costs as a result of the demand management initiative being implemented.

Origin believes that demand management incentives should be accessible to all retailers and applied in a competitively neutral way. End-use consumers should be given incentive to take up demand management and retailers, not DNSPs, are the interface where individual contracts are negotiated.

8. OTHER ISSUES IN RELATION TO THE WEIGHTED AVERAGE PRICE CAP

8.1 Unforeseen cost pass-through mechanism

Origin does not object to the inclusion of a mechanism in the price control formula to allow unforeseen material costs to be passed through provided there is an equal pass-through mechanism allowed in the regulated retail tariffs.

8.2 Risk hedging/benefit sharing factor

Origin agrees with the Tribunal not to introduce a volume forecast risk hedging factor in the price control formula. Origin believes that a risk hedging mechanism is intrinsically built into the application of the WACC in price regulation. Specifically, the WACC parameters include adjustments for risk and therefore applying an additional risk hedging factor and including this in the price control formula artificially inflates the distribution service costs.

8.3 Revenue from pole and duct rentals

Origin strongly opposes the Tribunal’s draft decision not to make any adjustment to the DNSPs’ notional revenue requirements used in the WAPC for revenue earned from pole and duct rentals. Origin notes the Tribunal’s acknowledgement that:

- pole and duct rentals are non-distribution services;
- regulated assets are used to provide these services; and
- DNSPs do not currently allocate any regulated asset costs to them.

This is an example of poor cost allocation (and the potential for cost shifting) referred to previously. It is also an unnecessary cost for ordinary network users. Origin calls on the Tribunal to rectify this competitive neutrality problem and create a level playing field for second tier retailers trying to enter the competitive market.

8.4 Capital contributions

Origin has no comments on this issue. Capital contributions associated with monopoly services have been dealt with separately by the Tribunal.
9. CHARGES FOR MISCELLANEOUS AND MONOPOLY SERVICES

Origin does not have an issue with the setting of miscellaneous and monopoly charges provided they are reasonable and can be passed through to end-use consumers in full, plus a retail administrative charge. Origin believes that a similar distribution administrative charge is already bundled in the service charges listed and therefore retailers should be allowed to impose a surcharge in order to cover the costs of implementing them in their systems. Where the actual revenue earned from these services exceeds the estimate used in the WAPC, adjustments need to be made to the DNSPs’ notional revenue requirements and new X-factors recalculated.

Origin concurs with concerns that the DNSPs’ financial systems could not provide sufficiently disaggregated information about the costs of miscellaneous and monopoly services. Origin calls on the Tribunal to ensure that there are proper ring fencing requirements in place, supported by stringent accounting separation code, to prevent cost shifting opportunities.

10. TRANSMISSION RECOVERY ARRANGEMENTS

Origin is satisfied with the Tribunal’s approaches to transmission cost recovery provided it can be fully passed through to customers without affecting the already very low retail margin.

The pass through of costs must be managed under transparent ring-fencing rules to ensure a level playing field for all prospective retailers seeking to compete in the NSW electricity market.

In this context Origin proposes that all financial and service data relating to regulated distribution services be published, on the basis that distribution is a natural monopoly activity. Accordingly there should be no negative competitive impacts arising from such disclosure.

11. LIMITS ON PRICE MOVEMENTS

Origin strongly advocates a “light-handed” approach to regulation. Notwithstanding that, Origin wishes to stress the importance of applying transparency and consistency in the application of limits on price movements for network and DUOS tariffs or the restructuring of tariffs.

Origin does not have a preferred approach to determining the amount by which network prices should move or how network tariffs might be restructured. However, Origin is firmly of the view that changes to network tariffs must be appropriately reflected in retail prices in order to provide effective price signalling to end-use consumers. Additionally, changes to tariffs must be done in consultation with all retailers, and the retailers must be given ample time to make necessary adjustments to retail tariffs and to implement these adjustments. Retailers should be allowed to recoup the costs of implementing tariff adjustments in their systems as a result of the network tariff restructuring.

Again, the pass through of network price changes should be managed under transparent ring-fencing rules to ensure a same level playing field for all prospective retailers seeking to compete in the NSW electricity market.
12. **PRICE SETTING ARRANGEMENTS FOR NETWORK TARIFFS**

Origin calls for more disclosure on information relating to changes in tariffs, tariff structure, consumptions and costs. As demonstrated previously in this submission, there are many opportunities for cost shifting when a business operates in both distribution and retailing, or monopoly and contestable businesses. Inadequate information disclosure allows for opportunities to be overlooked resulting in unnecessary costs to consumers.

In this context Origin proposes that all financial and service data relating to regulated distribution services be published, on the basis that distribution is a natural monopoly activity. Accordingly there should be no negative competitive impacts arising from such disclosure.

13. **REGULATION OF EXCLUDED DISTRIBUTION SERVICES**

Origin is satisfied with the general approach adopted by the Tribunal in defining prescribed distribution services by exclusion and excluded services to include customer funded connections, customer specific ancillary services, metering services and public lighting.

Origin is also satisfied with the Tribunal’s intention to apply “light-handed” regulation to excluded distribution services and to remove regulation where the services satisfy a ‘competition test.’

14. **CONCLUSION**

Origin reiterates the difficulties associated with competing in a market without a level playing field, where almost all incumbent retailers have a stapled distribution business, and there is little incentive for retailers to enter the general mass market. In this context, Origin urges the Tribunal to ensure that the cost benchmarks reflect all actual costs while allowing an adequate rate of return to retailers without compromising the ability to attract and retain customers away from regulated offers.

Origin urges the Tribunal to develop more stringent accounting separation requirements and more transparent information disclosure guidelines to promote effective ring fencing of DNSPs and their Standard Retail Suppliers. Consistent with the Tribunal’s view, Origin urges the Tribunal to publish all financial and service data relating to distribution services, on the basis that distribution is a natural monopoly activity. Origin believes there should not be any negative impacts arising from such disclosure.

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Origin Energy welcomes questions and comments on this submission by the Tribunal. Please contact -

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