09 September 2013

Dr Peter Boxall
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

Lodged electronically

Dear Dr Boxall

IPART EARLY TERMINATION FEES: Electricity Issues Paper, August 2013

Origin Energy (Origin) appreciates the opportunity to respond to the Independent Pricing and Regulatory Tribunal's ***Early Termination Fees: Electricity Issues Paper***.

IPART has identified two possible ways in which its terms of reference may be interpreted:

- One is to include some of the costs that a retailer would avoid if the customer had not signed the contract;
- Another view is to include those costs that a retailer would incur if the customer did not complete the contract term.

Origin recommends that IPART adopt a third approach, which is to consider the cost incurred by a retailer to replace those customers that terminate their contract early. This approach is explained in the attached submission.

Origin notes that there are already market offers available from most retailers in NSW without an early termination fee (ETF). Given these products are widely promoted on retailers' web sites Origin does not believe that setting a low ETF would, as IPART suggests, "remove a barrier to switching for some customers, particularly if the base ETF cap is set at a low level". Indeed setting an ETF cap too low for all offers may constrain product innovation, customer choice and hence competition. Origin suggests that IPART should therefore weight its assessment of an ETF cap at the higher end of what could be considered to be a reasonable range.

Should you have any questions or wish to discuss this information further, please contact Keith Robertson (Manager, Retail Regulatory Policy) on (02) 9503 5674.

Yours sincerely,

Keith Robertson
Manager Retail Regulatory Policy

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1. Background

IPART has been asked to specify a maximum amount (or amounts) that retailers may charge for the early termination of:

- a fixed term contract (or the fixed benefit period of a contract) for the sale of electricity, and/or
- a fixed term dual fuel contract (or the fixed benefit period of a dual fuel contract) in relation to the sale of electricity.

The terms of reference issued to IPART specify that this maximum amount (or amounts) must reflect a retailer's reasonable costs in giving effect to the early termination of the contract. It must not include an estimate of costs based on lost supply and lost profit, or an estimate of inducement costs not recovered due to the early termination of the contract. However, retailers will be able to add an (uncapped) amount that reflects these inducement costs to the amount IPART specifies.

The amount of these inducement costs must represent the monetary costs to the retailer of any up-front inducements offered to the customer, calculated on a pro rata basis.

IPART describes the fee it has been asked to determine as a cap for the "base early termination fee" (base ETF). IPART has indicated that in setting the base ETF it will balance the policy intent of providing protection to customers with the impact that regulating ETFs may have on consumer prices and the competitive market, including the level and diversity of product offerings.

2. Cost Types retailer seek to recover through an ETF

IPART has sought comment on the types of costs that retailers typically seek to recover through their current ETFs.

Origin agrees with the broad set of costs identified by IPART:

- Customer acquisition and marketing costs to re-acquire a customer
- Investments made on behalf of customer
- Administrative costs of establishing a new account
- Energy purchase adjustment costs
- Administrative costs of finalising a customer account, including increased payment delinquency rates.

Origin notes that the cost of finalising the account may also include the cost of capital for final bills that are paid late, commissions paid to mercantile agents to recover outstanding bills, the cost of bad debt write offs, the cost of handling calls received by early terminating customers and the cost of retailers' outbound calls (save campaigns) that seek to retain the customer (mitigating against other early termination costs).

As discussed further below Origin does not expect that there is currently a significant recovery of investments made on behalf of the customer. Where this is the case they would currently largely be classed as recovery of an inducement (not part of the base ETF) or form part of the energy purchase cost adjustment cost. As IPART notes this position may change in the future, particularly if retailers make investments in advanced metering technologies that cannot otherwise by recovered.

The extent to which retailers currently include each of the costs noted above will depend on the approach taken to assess costs. This is discussed in section 3 below.

3. Approach to Assessing Costs

IPART has identified two possible ways in which its terms of reference may be interpreted:

- One is to include some of the costs that a retailer would avoid if the customer had not signed the contract;
- Another view is to include those costs that a retailer would incur if the customer did not complete the contract term.

Origin recommends that IPART adopts a third approach, which is to consider the cost incurred by a retailer to replace those customers that terminate their contract early (Early Terminator). This is considered as a separate exercise from retailers' efforts to grow their customer base more generally.

Origin has set out its view on appropriate categories for costs under this preferred approach (section 3.1 below) as well as commenting on cost recovery under IPART's suggested options (sections 3.2 and 3.3 below).

3.1 Origin's Preferred Approach to establishing the base ETF cap- Reacquiring Customers

Retail customers terminating their contract before the agreed expiry date (Early Terminators) create a marginal exposure (i.e. a potential loss) for a retailer's hedge book. This can be fully mitigated by maintaining a neutral net customer and volume position rather than realising a loss in the retailer's hedge book. This involves entering the market to "re-acquire" or replace each Early Terminator (as a separate exercise from growing the customer base more generally).

The table below notes the cost categories (consistent with those identified by IPART) that should be included in this proposed approach to estimating ETF base costs.

Table 1. Origin's Preferred Approach Reacquiring Customers

Type of Cost	Include in ETF?	Comment
Customer acquisition and marketing costs to re-acquire a customer	Yes	Include direct channel costs to acquire replacement customer. Exclude broader marketing costs that may have been incurred anyway
Investments made on behalf of customer	No	Should be included in retailers assessment of inducements
Administrative costs of establishing a new account	Yes	These costs are incurred as a result of the replacement customer signing the contract.
Energy purchase adjustment costs	No	Customer load is maintained under the replacement approach
Administrative costs of finalising a customer account, including increased payment delinquency rates	Yes	The cost of finalising the account is an incremental cost as there also remains the cost of finalising the replacement customer account.

None of the costs noted above should be considered to be a cost of lost supply or profit.

3.2 Possible Approach - Costs retailer would avoid if the customer had not signed contract

IPART has sought comment on a possible approach to assessing costs under which "One is to include some of the costs that a retailer would avoid if the customer had not signed the contract".

Origin's preference is for the replacement customer approach (section 3.1) as this more accurately reflects the loss a retailer is likely to incur. However of the two approaches proposed by IPART Origin considers that the "Customer had not signed a contract" approach as summarised by IPART in Table 3.1[1] is the more reasonable means of estimating the base ETF cap. Origin supports the effect of the approach in Table 3.1 which is to allow for recovery of sales channel related costs.

Origin notes that IPART's description of the "Costs retailer would avoid if the customer had not signed contract" may need some refinement to more clearly exclude those normal retail costs of operating a contract that are offset by revenue during the term of the contract prior to the early termination event.

Table 3.1 Costs retailer would avoid if the customer had not signed contract

Type of cost	Vary as a result of signing contract?	Comment
Customer acquisition and marketing costs (excluding inducement costs)	Some no, some yes	Some costs may not have been incurred had the customer not signed the contract (for example, commissions paid to brokers) while other costs may have been incurred regardless (for example, marketing costs).
Investments made on behalf of customer	Yes	These costs are incurred as a result of the customer signing the contract.
Administrative costs of establishing a new account	Yes	These costs are incurred as a result of the customer signing the contract.
Energy purchase adjustment costs	Yes	The costs of entering into energy purchase arrangements for a period based on the length of the contract do not vary if the customer terminates early. However, those of rebalancing the energy purchase portfolio to account for the reduced load when a customer terminates early do and so are costs of giving effect to the early termination.
Administrative costs of finalising a customer account, including increased payment delinquency rates	Some no, some yes	Some of these costs – such as finalising the bill and returning the security deposit – will be incurred regardless of early termination However, the timing/frequency of those costs might be affected by early terminations. Further, the inclusion of the ETF in the final bill might affect payment delinquency rates.

Source: Table 3.1, Early Termination Fees, Regulating the fees charged to small electricity customers in NSW Electricity — Issues Paper, IPART, August 2013

3.3 Possible Approach - costs that a retailer would incur if the customer did not complete the contract term.

IPART has sought comment on an approach under which the view taken "...is to include those costs that a retailer would incur if the customer did not complete the contract term."

Origin does not consider this approach as adequate as it does not recognise the sales channel costs that a retailer incurs in replacing (or acquiring) the early terminating customer. These are significant costs that are ordinarily recovered through the term of the customer contract.

While Origin does not support this approach, Origin agrees that IPART's assessment of costs summarised in Table 3.2 (replicated below) is logically consistent with the approach. None of these costs should be considered to be a cost of lost supply or profit.

[1] **IPART EARLY TERMINATION FEES: Electricity Issues Paper, August 2013**

Table 3.2 Costs retailer would incur if the customer did not complete the contract

Type of cost	Vary as a result of early termination?	Comment
Customer acquisition and marketing costs	No	These costs are incurred in winning the customer and so do not vary as a result of early termination.
Investments made on behalf of customer	No	These costs are incurred in establishing the services require to meet the retailers obligations under the contract and so do not vary as a result of early termination.
Administrative costs of establishing a new account	No	These costs are incurred in establishing the account and so do not vary as a result of early termination,
Energy purchase portfolio adjustment costs	Yes	The costs of entering into energy purchase arrangements for a period based on the length of the contract do not vary if the customer terminates early. However, those of rebalancing of the portfolio to account for the reduced load when a customer terminates early do and so are costs of giving effect to the early termination,
Administrative costs of finalising a customer account, including increased payment delinquency rates	Some no, some yes	Some of these costs – such as finalising the bill and returning the security deposit – will be incurred regardless of early termination However, the timing/frequency of those costs might be affected by early terminations. Further, the inclusion of the ETF in the final bill might affect payment delinquency rates.

Source: Table 3.2, Early Termination Fees, Regulating the fees charged to small electricity customers in NSW Electricity — Issues Paper, IPART, August 2013

4. What is the level and range of relevant costs?

IPART has sought comment on the level and range of the costs reasonably associated with giving effect to early termination.

In section 3.1 Origin noted the cost categories that should be included when setting the cap on the base ETF. Each cost category is considered in further detail below. Origin will provide its estimate of the costs for each of these items in a confidential submission.

4.1 Customer Acquisition and Marketing costs

Origin agrees with IPART's observation that acquisition costs will vary over time and by type of retailer and customer. Origin therefore supports the use of IPART's recent estimate of customer acquisition cost at $150 to $190 per new customer.[2] This was based on an assessment of both public information and confidential data provided by a range of retailers.

[2] Review of regulated retail prices and charges for electricity From 1 July 2013 to 30 June 2016, Electricity — Final Report, June 2013

Origin acknowledges that marketing costs are difficult to attribute directly to a replacement customer and on this basis it may be more reasonable to focus on the direct channel and customer onboarding costs. Origin has provided IPART with its acquisition costs on a confidential basis separating out these elements.

4.2 Investments made on behalf of the customer

Many retailers including Origin have made substantial investments to support their mass market customer base. These include investments in power stations, long term commitments under Power Purchase Agreements (PPA) and the development of information technology systems.

The costs of power station investments or PPA commitments are dealt with under energy purchase adjustment costs (below).

Origin's proposed approach of re-acquiring a customer addresses recovery of IT systems investment costs as the investment cost is recovered from the replacement customer.

While metering assets or other service investments may in the future become a significant cost, this is not currently the case. Origin proposes that this issue be addressed when more is known about the NSW Government's smart meter policy.

4.3 Administrative costs for negotiating and preparing the contract and processing the customer transfer

The costs of developing products, pricing and contracts are significant but substantially less than the direct sales costs of acquiring a customer. Under Origin's proposed approach (section 3.1) these costs would not be considered as an incremental cost.

The cost of onboarding the customer is however directly attributable to the additional "reacquisition of a customer".

4.4 Energy purchase adjustment costs

Origin's proposed approach of reacquiring a customer avoids the need to estimate wholesale purchasing costs arising from the loss of a customer.

Should IPART adopt one if its proposed methodologies then an energy purchase adjustment cost should be included. There are a number of possible approaches that could be adopted to estimate this cost. Origin's own cost would be estimated as the difference between its generation cost and the current market value of wholesale contracts. Origin would be pleased to provide further cost information on a confidential basis.

Recognising that retailers will have varying energy purchase costs Origin suggests that IPART apply the wholesale cost assessments established as part of its recent electricity price determination. The energy purchase cost adjustment should be calculated as the difference between IPART's energy cost allowance and IPART's estimate of the market cost of energy purchases. This represents the cost retailers incur assuming they purchase energy at IPART's Energy Cost Allowance (a blend of LRMC and Market cost estimates) and then mitigate their potential losses by selling their energy purchases at IPART's estimate of market cost for FY14. For simplicity a weighted average across the three network areas would be preferred.

Approach to estimating energy purchase cost adjustment for FY14 ($12/13 $/MWh)

		Endeavour	Essential	Ausgrid
IPART's Energy Purchase Cost Allowance[3]	a	80.59	69.39	79.89
IPART's Market Based Energy Purchase Cost Estimate[4]	b	67.34	60.70	65.62
Energy purchase cost adjustment	a-b	13.25	8.69	14.27

Origin notes that it may be possible to derive a view of the energy purchase cost adjustment with reference to option prices. However given the lack of liquidity and transparency for these products using IPART's purchase cost assessment is preferred.

4.5 Direct costs of terminating the contract early

Under Origin's proposed approach of re-acquiring a customer the cost of finalising the replacement customer account is in addition to the cost of finalising the original customer account.

The additional costs of terminating the contract include:

- Back office costs of account closure
- Costs of issuing final bill & reminder notices
- Call centre costs of addressing queries relating to final bill
- Credit team costs in managing debt collection
- Cost of capital for final bills that are paid late
- Mercantile agency commissions
- Final debt write offs

Origin notes that final bills have a higher level of delinquency than an average bill.

5. Impact on Competitive Market

IPART has sought stakeholder's views on the impacts of the introduction of a base ETF cap for consumer prices and the competitive market.

IPART notes that:

> "if we were to set a base ETF cap that recovered a reasonable proportion of these costs, there is less risk of detrimental impacts on electricity prices and competition. However, Government, retailers, consumer groups and IPART would need to engage with customers to ensure they understand that this amount is a cap, and that they can shop around to find a product offering that best suits their needs (including products that include no ETF)."

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[3] Table 6.2 Review of regulated retail prices and charges for electricity From 1 July 2013 to 30 June 2016, Electricity — Final Report, June 2013

[4] Table 6.4, Review of regulated retail prices and charges for electricity From 1 July 2013 to 30 June 2016, Electricity — Final Report, June 2013

Origin does not consider there is a need to regulate ETFs in a competitive market and that IPART should set the cap at the upper end of a reasonable range.

ETFs are a feature of many competitive markets and are generally well understood by consumers. In the NSW electricity market many retailers (including Origin, AGL, Lumo, EnergyAustralia, Red Energy) offer energy plans with and without ETFs. Given the availability of energy plans without an ETF Origin does not believe that setting a low ETF would as IPART suggests "remove a barrier to switching for some customers, particularly if the base ETF cap is set at a low level".

It is of note that prior to the introduction of an ETF cap in Victoria Origin did not apply an ETF as a point of differentiation. Following the introduction of the very low ETF cap in Victoria there was little competitive benefit in differentiating offers by ETF and Origin subsequently introduced an ETF.

It is difficult to determine the overall impact of the introduction of a cap on ETFs in the Victorian market given the number of other factors at play and the difference in market conditions between jurisdictions.

On the basis that there are already market offers available from most retailers without an ETF and that setting an ETF cap too low for all offers may constrain product innovation, customer choice and hence competition, IPART should weight its assessment of an ETF cap at the higher end of what it considers to be a reasonable range.