IPART REVIEW OF

REGULATED RETAIL ELECTRICITY TARIFFS

A Submission from Origin Energy

May 2002

1. Purpose of the Regulated Tariff Review

The ongoing requirement for regulated tariffs is comes from the presumption that in the early stage of the contestable market, the majority of the mass-market customers will remain on regulated tariffs before the true economics of competition can be achieved. Historically, the regulated tariffs were set under the framework of a regulated electricity industry, which embodies the regulated economics and the importance of delivering the essential service to households. As a result, the current regulated tariffs are not fully cost reflective in today's environment. In Origin Energy's view, the current review of the regulated tariffs should be directed at encouraging a vigorous competitive market by unwinding cross subsidies and reflecting the true costs of supply in the regulated tariffs for each customer segment.

2. Appropriate Target Tariffs

Types of Target Tariffs. The current target tariffs fail to account for the special characteristics of the controlled load tariffs. The current tariffs are under recovered, and the current structure of the target tariffs has exacerbated the situation. Considering the popularity of the controlled load tariffs, there is an urgent need to have separate targets for the controlled load tariffs.

Structure of Target Tariffs. The fixed and variable structure should reflect the costs of the fixed/variable nature, which in turn leads to total revenue being recovered from each tariff. Flexibility should be given in how each tariff can be structured.

Green Costs. With the increased environmental compliance requirements from federal and state governments, the costs of meeting these requirement are material and need to be fully passed through to the regulated tariffs, and thus provide a price signal to the end users. The compliance requirements are imposed on both the incumbents and the new entrants. Allowing for full green pass through is a first step towards cost reflectivity.

Prudential Cost and NEMMCO Charges. Prudential costs required by NEMMCO have increased in line with the increase in Value of Lost Load (to $10,000/MWh). These costs should also be passed onto the regulated customers through the target tariff mechanism.

Ancillary Charges. Similarly, the introduction of new ancillary service market in late 2001 has seen an increase in the ancillary charges. This effect has also been shielded by the current target tariffs and needs to be addressed explicitly going forward.

Cost to Serve. When cost to serve was benchmarked at $40-$60 per customer, IPART excluded items reasonably identified and incurred by retailers. As a consequence the benchmark does not reflect market reality, and its application impedes the development of a competitive market. Our specific concerns include:

- Much of the information used in establishing this benchmark came from companies where the accounting ring-fencing of retail and network operations had not started or was incomplete (see below).
- The information was based on historical data (1997/98 in most cases) before the industry reform process commenced and businesses operated on the basis of fully depreciated legacy IT systems and simplified processes that are unsustainable in the reformed industry. Almost all retailers have since spent time and financial resources on replacement and upgrade of systems, the costs for which (depreciation and operating costs, licences etc) need to be acknowledged in setting future regulated tariffs.
- Similarly, the data did not include the costs associated with a deregulated market. These costs include higher regulation and compliance costs, gas supply management (including interactions with the wholesale market operator), increased risk and higher cost of capital.
- Unrealistically low expectations regarding retail margins that are inconsistent with the risk profile and return on capital requirements of the disaggregated retail businesses.

The provision of market offers below regulated tariffs will only occur if the regulated tariffs reflect the true costs to serve. Competitive activity can only be funded through the provision of an allowance made in starting aggregate revenue (the regulated tariff) to cover increased costs incurred by retailers. If this is not provided for competition will not evolve. OE strongly recommends IPART reconsider the benchmark.

There are a number of independent studies of cost to serve both in Australia and overseas that have been conducted since the IPART study and which more closely reflect the reality of operating in a competitive market with appropriate ring-fencing. To Origin's knowledge, these studies have consistently indicated benchmark costs well in excess of $40-$60 per customer[1].

Other Retail Costs. The determination excluded increased costs for marketing and bad debts due to FRC and made no specific allowance for working capital. New market offers will not be provided if they cannot be supported through increased marketing, whilst the ability to change retailer inevitably increases the level of skipping to avoid debt. Similarly the cost of

[1] These studies include (i) OFGEM: *"Review of Public Electricity Suppliers 1998 to 2000"* (various reports October-December 1999); (ii) Datamonitor: Minimise the cost to serve and achieve customer satisfaction – A pan-European analysis (2001); (iii) Productivity Commission: Electricity Prices and Cost Factors (August 2001).

working capital is a cost of doing business and cannot be excluded from Retail Costs.

Ring-fencing and Cost Allocation. Ring-fencing between the NSW network and retail businesses, and cost allocation and strict implementation of the accounting rules is urgently required. In the past there has been limited transparency in cost allocation between the two businesses and inconsistency in the application of accounting rules. These factors can significantly skew the costs reported for each business and therefore the regulated tariff process for both retailers and networks. Moreover, the absence of appropriate ring-fencing directly distorts the competitive retail market dynamics, limiting the capacity of new retailers to enter the market. We would encourage IPART to consider the issue of retail tariffs in conjunction with progressing the work on Accounting Separation Standards.

FRC costs. In the current determination, IPART has allowed for $5 per customer for FRC cost, due mainly to lack of information at the time. In preparation for FRC, retailers have not only invested extensively in new customer information systems (see above), but are required to develop systems and processes directly related to managing customer transfers, market interfaces etc. Origin's most recent analysis has indicated that further costs are being imposed on the retail businesses due to the extent of "manual" processing required to manage the market systems, processes and interfaces and to ensure compliance with privacy and other regulatory requirements.