

**Origin Energy Retail Ltd  
Response to  
Independent Pricing and Regulatory Tribunal (IPART)  
Review of Gas and Electricity Regulated Retail Tariffs  
Issues Paper**

**January 2004**

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# 1. Introduction

Origin Energy Retail Ltd (“Origin”) welcomes the opportunity to comment on the Independent Pricing and Regulatory Tribunal (IPART) ‘Review of Gas and Electricity Regulated Retail Tariffs - Issues Paper’.

Origin, as a standard natural gas retailer for Albury and the Murray Valley in NSW, has previously made a submission to the Tribunal in response to the Issues Paper. Origin would like to take this opportunity to reiterate its views as a participant in the electricity market of NSW.

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

In NSW, Origin is a small retailer of gas and electricity, with a number of LPG customers. Origin retails natural gas to approximately 18,000 customers in the Albury and Murray Valley regions, and around 700 customers in the central west (Dubbo, Parkes, Forbes and Wellington). Origin also has a small number of larger contestable electricity and gas customers across other parts of NSW.

With the introduction of full retail contestability, Origin seeks to enter markets that are transparent, can offer the opportunity to earn a reasonable rate of return, and can provide a level playing field for all market participants.

# 2. General Comments

Origin is concerned about how the benchmark cost ranges will be interpreted and used. It is important that these benchmarks are viewed in a way that encourages the development of competition and security of supply for small retail customers in NSW.

Origin believes that in constructing benchmarks for servicing small retail customers supplied under a standard form contract, it is critical that the Tribunal not underestimate:

- the true energy purchasing costs;
- total retail operating costs;
- the rate of return required to fully compensate for risk.

Such a balanced view must go beyond theoretical benchmarking exercises to consider the actual costs facing the businesses and the requirements of equity owners for a fair return on capital investment.

It is also Origin’s view that the Tribunal should have special regard to the benchmark costs applied to a stand-alone privatised ring-fenced retailer servicing small retail customers supplied under a standard form contract, where costs and overheads can not be shared between businesses.

In this response Origin has focused on the following key issues outlined in the Tribunal’s Issues Paper:

- the most appropriate form of regulation for regulated retail tariffs;
- the most appropriate levels of costs to be recovered;
- the most appropriate structure for retail tariffs;
- the basis upon which non-tariff charges be regulated.

These issues are addressed in detail in the following sections of this paper.

### 3. What is the most appropriate form of regulation for retail tariffs?

*The Tribunal seeks comment on what form of regulation will best assist the Tribunal in meeting its objectives of moving all regulated tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks.*

Origin refers to the Minister's Terms of Reference<sup>1</sup> (TOR) for the Tribunal's investigation and would like to point out that the Tribunal, under the TOR, must consider the Government's 'policy aim of reducing customers' reliance on regulated prices and the effect of its determination on competition in the retail electricity market.'

The Minister states in the TOR 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.' The Minister goes on to state that 'the level of regulated prices for small retail customers is a crucial factor in encouraging new entry in the retail sector. If the level is set too low, it is not possible for new retailers to attract small retail customers away from the regulated price. This can reduce scale economies for new entrants, increasing their costs, making it more difficult for them to compete.' Origin is a strong advocate of competitive energy markets and therefore endorses these statements.

Origin notes that the Tribunal's stated primary objective in setting the form of regulation for both electricity and gas sectors is 'to move all regulated tariffs towards cost-reflective levels without exposing customers on under-recovering tariffs to unacceptable price shocks.' Origin disagrees with this view as it is not in line with the Minister's TOR, which requires the Tribunal to ensure that 'regulated tariffs cover the costs ... while recognising consumers' ability to adjust to new prices.'

The Tribunal also states that 'in some cases, price constraints may mean that regulated retail tariffs will not reach cost reflective levels by June 2007'. It has been proven<sup>2</sup> that adopting the price path to target tariffs approach, combined with rebalancing constraints applied in the past, have not solved the problem and will not solve the problem moving into the next determination. Given the proposed

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<sup>1</sup> Minister of Energy NSW (2003): *Terms of reference for an investigation and report by the Independent Pricing and Regulatory Tribunal on regulated retail tariffs and regulated retail charges to apply between 1 July 2004 and 30 June 2007 under Division 5 of Part 4 of the Electricity Supply Act 1995.*

<sup>2</sup> Please refer to Origin Energy's gas submission (December 2003): *Response to Independent Pricing and Regulatory Tribunal Review of Gas Regulated Retail Tariffs.*

network prices<sup>3</sup> and transmission charges<sup>4</sup>, Origin has serious doubts that using the same price path and rebalancing constraints would help eliminate the issue of revenue tariffs under recovering on costs for the majority of customers by 2007.

The Tribunal goes on to state that 'it may be appropriate that the Tribunal considers setting retail tariffs for new customers (or new connections) at cost reflective levels. This would mean, however, that similar customers in the same area would be on different tariffs.' Origin does not consider setting differential prices at cost reflective levels for new customers only to be a solution to the current issue of under recovering tariffs. As was demonstrated in Origin's gas submission, such a pricing strategy would not solve the issue for the majority of customers going forward. Further, the implementation of systems and processes for such a strategy would be complex and costly, which would further add to the cost of supply.

It is for the above reasons that Origin is firmly of the opinion that retail tariffs in NSW need to be reset in a one-off adjustment in 2004 to meet the Tribunal's objective of achieving cost reflective tariffs for all customers.

After this one-off re-adjustment, it will then be possible to adopt average price path approach as suggested by the Tribunal. This, in Origin's opinion, would allow the Tribunal to adopt a light handed approach to regulation and let market forces self regulate a competitive market.

#### 4. What are the appropriate levels of costs to be recovered?

*The Tribunal seeks comment on the most appropriate treatment of the various cost components to ensure that retail charges are at, or close to, cost reflective levels for all small retail customers by 2007.*

Origin concurs with the Tribunal that 'if default tariffs [are] set at cost reflective levels, they should operate in a 'neutral manner' and strengthen the incentives on retailers to operate efficiently.' The problem is, from Origin's experience, and which Origin has already detailed in its gas pricing submission, the current retail tariff levels are far from being cost reflective.

The majority of Origin's current regulated natural gas tariff customer base in Albury and the Murray Valley NSW regions is paying prices that are significantly lower than the cost Origin incurs to supply these customers. Origin's analysis of the NSW incumbent retailers' default customers also indicates that, for a long time, the costs of supplying electricity to default customers in these areas have not been fully reflected in the prices that these customers are charged.

Origin notes that the Tribunal have not included in its comparison of retail operating cost benchmarks a similar study by the consultant Charles River Associates (CRA) for the Department of Infrastructure in Victoria (DOIV) in late 2002. Origin also draws the Tribunal's attention to the most recent study carried out by the same consultant for DOIV in December 2003.

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<sup>3</sup> Independent Pricing and Regulatory Tribunal (January 2004): *NSW Electricity Distribution Pricing 2004/05 to 2008/09 - Draft Determination*.

<sup>4</sup> TransGrid's Application to the Australian Competition and Consumer Commission (October 2003): TransGrid proposes an average price increase of 32% over the next regulatory period, with the first year increase of 15.37% in 2004/05.

## 4.1 Electricity purchase costs

Origin understands that there has been a delay in the planned release of the cost benchmarks and wholesale energy costs report. Origin is waiting for the outcomes from the consultant's study before making any specific comments about the electricity cost benchmarks. Notwithstanding that Origin have the following general comments.

In determining electricity costs for electricity retailers, regulators in Australia have not relied on the electricity spot market prices. Regulators have accepted that the retailers' costs are based largely on the cost of a portfolio of physical and financial hedge contracts and that any significant reliance on spot market purchases would threaten the financial viability of the company.

Origin does not support the continuation of the Electricity Tariff Equalisation Fund (ETEF) and strongly believes that it should be abolished altogether. The ETEF provides advantages to retailers, who have access to it, through reduced risk costs when other retailers have to hedge their risks through the market and, in the process, incurring all applicable transaction costs<sup>5</sup>. The ETEF benefits the incumbent retailers even more by allowing them to transition from the ETEF's purchase rates to actual wholesale market costs without incurring the same level of costs which would otherwise be incurred by new entrant retailers. Effectively, it means first tier retailers would be able to enjoy the safety of the ETEF during times of high wholesale prices and take advantage of low wholesale prices when it suits them. This would create unfair competitive disadvantages for second tier retailers seeking to enter NSW.

## 4.2 Wholesale gas costs

Origin draws the Tribunal's attention to the events surrounding the recent Moomba gas explosion and reiterates that wholesale gas costs are not the same if supplied via different transmission systems and from different gas fields. Origin, therefore, urges the Tribunal to be careful not to set the same benchmarking exercise for retailers whose gas is supplied from the Cooper-Basin fields as for those whose gas is supplied from Victorian gas supply contracts and shipped via the Principal Transmission System (PTS) in Victoria.

Origin also refers the Tribunal to its December 2003 submission, where Origin discusses in more detail other costs prudent retailers incur in wholesale gas purchasing.

## 4.3 Network charges

The Tribunal has recently released its Draft Determination for electricity distribution prices. Origin notes that the Tribunal intends to allow the DNSPs price rises of CPI plus up to 6.5% in the first year of the new regulatory control period, with subsequent rises well in excess of the expected annual inflation. Origin will be making a submission to the Tribunal, which will address specific issues raised in that Draft Determination.

Notwithstanding the above, Origin is firmly of the view that network charges must be fully reflected in retail prices. Origin therefore supports the Tribunal's approach

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<sup>5</sup> The Tribunal acknowledges this in the Issues Paper (pp.11): "... the Tribunal has previously decided not to include hedging costs in the retail margin for NSW electricity retailers, as the Electricity Equalisation fund provides a form of automatic hedging for retailers supplying customers on regulated tariffs."

to allow for the pass through of network charges directly to customers. Origin further advocates that the pass through of network charges should be managed under transparent ring-fencing rules to ensure the same level playing field for stand-alone and second-tier retailers seeking to compete in the NSW electricity market.

Origin also draws the Tribunal's attention to the fact that distribution charges for Albury and the Murray Valley regions are regulated by the ESC. Allowance for the pass through of network charges to customers in these areas should take account of the timing and costs of complying with the respective jurisdictional requirements.

#### 4.4 Retail operating costs

The Tribunal has cited a number of retail operating cost benchmarks from various states and markets stretching from 2000 to 2003. Origin notes that the Tribunal has not included the retail operating costs published for the most relevant and geographically closest region to NSW customers - that is the \$90 from the CRA study carried out for the Department of Infrastructure in Victoria in late 2002. The most recent study<sup>6</sup>, also carried out by CRA for DOIV in December 2003, uses the same \$90 number adjusted for inflation. Origin's own studies of the NSW energy businesses, however, indicates that the retail operating costs, when all appropriate costs are taken into account, are significantly higher than those quoted by the Tribunal in the Issues Paper.

Origin is not a "stapled" retail-distribution business and therefore does not have the opportunity to allocate costs to a network business that is not subject to substantial competition, nor has it the opportunity to gain economies of scale through sharing of overheads between the businesses. The implication is that, a stand alone standard retailer such as Origin has a higher cost benchmark than that of a "stapled" retailer-distributor. The Tribunal report does not appear to have made this distinction for Origin Energy.

The operating costs in energy retailing move largely in line with CPI - the largest component of cost is labour. Associated development/changes in market rules, retail codes, privacy legislation, and compliance have added to the customer management process and increased retailer costs. Origin proposes that the Tribunal consider, as a minimum, CPI increases year on year to the retail operating cost benchmark to cover the increased cost to retailers.

#### 4.5 Retail margin

The Issues Paper contains a table (Table A3.3) of retail profit margins for gas and electricity allowed by various regulators in different states stretching back to 2001. Origin notes with concerns that this table does not precisely define what costs are included or excluded from this benchmark data. Moreover, Origin is concerned with the validity of the benchmarks referenced by the Tribunal and that these retail margin benchmarks are largely based on circular cross-referencing with other state regulators rather than recognising actual retail costs or referencing independent studies.

Origin believes that the current retail margin is insufficient to encourage competition. The Tribunal's stated view is that 'retailers must be able to earn a net retail margin if their investment in the business is to be worthwhile.' The Minister also stated in his TOR that 'if regulated retail tariffs do not adequately reflect all

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<sup>6</sup> Charles River Associates, on behalf of Department of Infrastructure Victoria (December 2003): *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007)*.

of the costs of supply to small retail customers, both those customers and prospective competing retailers have little incentive to enter the competitive market.<sup>7</sup> Origin contends that the net retail margin for operating an electricity or gas retailing business should be sufficient to cover all applicable costs, including such costs as bad debts, credit, depreciation and amortisation, marketing and advertising<sup>8</sup>, legal services, and a return on capital employed.

The Tribunal's proposes the current retail margin (before interest and tax) benchmark in the range of 1.5 to 2.5 per cent for electricity and 2 to 3 percent for gas. Origin strongly contends that the retail margin proposed by the Tribunal is far too low. Origin is a commercial enterprise that has a responsibility to deliver appropriate returns on investment to its equity shareholders. Origin is therefore firmly of the opinion that such poor returns, as proposed by the Tribunal would encourage investors to exit the industry.

CRA suggested a net retail margin of between 5 and 8 percent as a reasonable margin to promote more effective competition<sup>9</sup>. Origin is firmly of the opinion that a minimum retail margin (EBIT/Revenue) of 5 per cent would be more acceptable for competing retailers to enter the market. Origin also suggests that a long term retail margin benchmark should be in the order of 5 to 10 per cent to take account of the high level of uncertainty of the revenues and margins that are exposed to uncontrollable events such as the weather; this exposure cannot be hedged at reasonable cost in Australia.

#### 4.6 Other costs

The Tribunal also refers to NEMMCO and Gas Market Company (GMC) costs as a direct pass through on a retailer specific basis. In addition to those costs, Origin Energy is liable to pay published VENCORP tariffs and VENCORP FRC rates for its customers in Albury and Murray Valley NSW and as such these costs, and their escalation year on year, should also be passed through to customers.

## 5. What is the most appropriate structure for regulated tariffs?

*The Tribunal seeks comment on issues regarding the structure of regulated retail tariffs, including whether an inclining block structure is a proxy for cost reflectivity and the implications of allowing more complex price structures for the objective of rationalising the number of regulated tariffs.*

Origin Energy is firmly of the opinion that regulated tariffs should reflect the underlying costs of supplying energy to customers and therefore supports a tariff structure that is cost reflective.

Origin is in favour of a tariff structure which has a fixed component and variable stepped components that mirror, as closely as possible, the underlying fixed and variable costs. Where current tariffs are significantly under recovering, Origin

<sup>7</sup> Minister of Energy NSW (2003): *Terms of reference for an investigation and report by the Independent Pricing and Regulatory Tribunal on regulated retail tariffs and regulated retail charges to apply between 1 July 2004 and 30 June 2007 under Division 5 of Part 4 of the Electricity Supply Act 1995.*

<sup>8</sup> Essential Services Commission (December 2003): *Special Investigation Proposed Retail Tariff Amendments - Final Report.*

<sup>9</sup> Charles River Associates, on behalf of Department of Infrastructure Victoria (December 2003): *Electricity and Gas Standing Offers and Deemed Contracts (2004-2007).*



believes that there needs to be a one-off adjustment to immediately bring both the fixed and variable components of those tariffs to cost reflective level.

Origin's analysis indicates that the application of a price path with constraints as used by the Tribunal in the past will not solve the under-recovering problem for the majority of customers. Only a once off re-set will deliver cost reflective tariffs and greater price stability going forward.

## 6. What non-tariff charges should be regulated?

*The Tribunal seeks submissions relating to the regulation of non-tariff charges including where possible the incidence and cost of different types of charges.*

Origin supports a light-handed approach to the regulation of retail non-tariff charges and the full pass through of network non-tariff charges directly to the end consumers.

The Tribunal recognises in the Issues Paper that non-tariff charges (or miscellaneous charges) are 'a result of a special request from a customer or upon the customer taking (or failing to take) certain actions,' and that 'these charges are not a routine part of retail supply services.' Origin also notes the Tribunal's concern about the potential equity problem affecting retail customers.

It is for the above reasons that Origin is firmly of the view that additional costs incurred as a result of special and/or non-routine services should be fully reflected in the miscellaneous charges. Additionally, Origin believes that a retailer should be allowed to pass on the additional administrative expense incurred when network operators carry out non-tariff services on behalf of a customer, and the retailer incurs the network non-tariff charges before then passing it onto the customer. This is based on the guiding principle that a retailer should be able to recover the fair and reasonable costs of additional services, including administration costs associated with third party charges. Managing this transaction imposes additional costs on the retail business, particularly in deregulated markets where separated retail and network businesses have new obligations, and customers have greater service expectations. It is worth noting that the Network companies bear no credit risk for these charges, this risk is passed to the retailers and must be managed by the retailers.

To maintain cost reflectivity, Origin also proposes to apply an annual CPI adjustment to all retail miscellaneous charges and the administrative component of network charges as they are mostly related to labour costs, which are expected to increase in line with CPI. Network charges would remain a straight pass-through.

## 7. Summary

From an overall perspective, Origin fully agrees with the Tribunal's view that it is essential for regulated retail prices to move to cost reflective levels for all small retail customers. However Origin notes that the previous price path determination has not brought prices to cost reflective levels. Origin believes that a price re-set to cost reflective levels in 2004, followed by the introduction of a smooth cost reflective price path to 2007, is the only realistic way of insuring:

- effective competition and promote competitive market conduct where customers are able to choose their retailer and the best product suited to them;

- greater price stability and a protection of the long term price, quality and reliability of essential services;
- sufficient incentive to enter the competitive market and to encourage long-term investment in the industry; and
- the future financial viability of the energy industry.

This strategy is in line with the Tribunal's stated objective of balancing the interests of consumers and retailers and, in Origin's opinion, represents the best solution to the problem where costs are significantly under-recovered through existing tariffs.

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 with little incentive for retailers to enter the competitive market. In this context, Origin urges the Tribunal to ensure that the cost benchmarks reflect all actual costs and also allow for an appropriate rate of return to encourage competing retailers to attract small retail customers away from the regulated price.

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

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