



17 May 2004

NSW Electricity Retail Pricing 2004/05 to 2006/07  
Independent Pricing and Regulatory Tribunal  
PO Box Q290, QMB Post Office  
NSW 1230

Re: Review of Regulated Retail Prices for Electricity to 2007

Thank you for the opportunity to respond to Draft Report and Draft Determination arising from the review of regulated retail prices for electricity to 2007. Origin has considered the review in the context of the Terms of Reference ("TOR") for the Review as set out by the Minister under section 43EB of the Electricity Supply Act 1995 (the "Act").

As stated in the Draft Report, for the purposes of section 43EB(2)(b) of the Act, the Tribunal 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 market (page 28). More specifically, the Tribunal is to ensure that regulated tariffs cover the costs of supply while recognising consumers' ability to adjust to new prices.

Origin's detailed comments are provided in the attachment. We highlight that in responding to the obligations under the Act, the Tribunal appears to have relied on two general themes, namely:

- establishing "efficient costs" for retail electricity supply, and
- ensuring "competitive neutrality" in its assessments of the regulated tariffs.

Origin contends that the obligations under the TOR are not adequately addressed by virtue of the Tribunal's interpretation of "efficient costs" and "competitive neutrality".

Therefore, while Origin understands the obligations on the Tribunal to "recognise consumers' ability to adjust to new prices" we believe that the Tribunal has placed too much weight on this consideration without fully addressing the other aspects of its obligations under the TOR.

Origin is also concerned with the complexity of the constraints that are being proposed with respect to increases in the retail component of the final tariffs. Origin cautions that by adding further complexity to the constraints, the Tribunal increases the possibility that retail tariffs will still be under-recovering in 2007, thus repressing further the opportunity for a competitive energy market to develop in NSW.

If you have any further queries regarding Origin's response to the review, can you please contact Ms Beverley Hughson on 03 9652 5702 in the first instance.

Yours sincerely

Gerald White  
National Manager, Strategy and Regulation  
Origin Energy Retail Ltd  
(Attachment)

**Independent Pricing and Regulatory Tribunal (IPART)  
Review of Gas and Electricity Regulated Retail Tariffs  
Issues Paper**

**Submission by Origin Energy**

**17 May 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) 'NSW Electricity Regulated Retail Tariffs - 2004/05 to 2006/07, Draft Report and Draft Determination'.

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 desires to become an active participant in competitive gas and electricity markets.

In New South Wales, 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 the same level playing field for all market participants.

## 2. General Comments

Origin has previously made submissions to the Tribunal in response to the 'Review of Gas and Electricity Retail Tariffs, Issues Paper'<sup>1</sup> and the 'NERA Report'<sup>2</sup>. In these submissions Origin has commented extensively on wholesale energy, retail operating costs, network costs and retail margins. Origin has repeatedly stressed the importance of the Tribunal approaching benchmarking in a way that encourages the development of competition including the development of competition to incumbent retailers in NSW.

Origin is disappointed that our comments in these submissions, while acknowledged in places, have not been taken account of in the draft determination. Origin would like to take this opportunity to strongly reiterate our views as expressed in these submissions.

The Tribunal maintains that regulated retail tariffs should be neutral with respect to competition. Origin's view is that the draft determination is not neutral and if adopted will:

- Set benchmarks at inappropriately low levels that are not supported by the industry,
- Set margin at a level that does not recognise the costs and risks facing new entrants and potential new entrants to the market,
- Inhibit the development of competition in the NSW electricity market,
- Is not consistent with the Tribunal's stated objectives and the Minister's Terms of Reference.

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<sup>1</sup> Review of Gas and Electricity Retail Tariffs, Issues Paper, October 2003.

<sup>2</sup> NERA Revised Report on Costs and Margin, February 2004.

### 3. Effective Competition in the NSW Electricity Market

Since January 2002 every customer in the NSW electricity market has had the option to accept a negotiated energy supply contract. In its draft determination the Tribunal describes a market with effective competition as one in which:

- 'new entrants have entered the market and actively compete with the incumbent retailers, taking market share from them';<sup>3</sup> and where
- 'there is potential competition whereby the threat of entry effectively disciplines the incumbents against abusing their market power but no entry actually occurs'<sup>4</sup>.

The Tribunal goes on to explain in its draft determination that there are few, if any, active players, aside from the incumbent retailers, in the NSW Electricity market. The Tribunal states that only three additional licences have been issued but notes, ambiguously, that 'not all of these are active'<sup>5</sup>. What is clear is that the incumbent retailers, the three biggest of whom still retain up to 98% of market share are not under any credible threat from new market entrants. There has been no effective change in market share since competition began two and a half years ago. The average churn level to another retailer for small electricity customers in NSW is 7% over two years, an average of 3.5% per year.

The Tribunal notes that average electricity prices for small retail customers are among the lowest in Australia - with only ACT electricity prices lower. The Tribunal goes on to state that since 1992/93, average prices (excluding Gst) for residential customers have decreased in real terms by 15 percent. The issue of tariffs not recovering on costs was first addressed by IPART in their 2000 electricity determination but under the current draft IPART determination small retail customers will still be under-recovering on cost in 2006/07. This continued policy of keeping energy prices virtually the lowest in the country while at the same time revenue does not even cover cost for small customers goes some way to explaining the slow development of effective competition.

Given the absence of full cost reflectivity until at least the end of the next determination it would seem reasonable to expect that the same issue will delay fully effective competition until at least 2007/08.

The alternative would be Origin's stated position that is for the Tribunal to make tariffs fully cost reflective in year one of the next determination. This would see a one off price adjustment for customers to price levels currently being seen in other Australian states. The move to cost reflectivity could see a rapid increase in development of truly effective competition - allowing a truly light handed approach to regulation.

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<sup>3</sup> IPART, Review of Regulated Electricity Prices to 2007, Draft Report and Draft Determination, pg 31.

<sup>4</sup> IPART, Review of Regulated Electricity Prices to 2007, Draft Report and Draft Determination, pg 31.

<sup>5</sup> IPART, Review of Regulated Electricity Prices to 2007, Draft Report and Draft Determination, pg 31.

This in turn would provide customers with:

- greater price stability and a protection against future or prolonged price shock;
- protection of the long term price, quality and reliability of essential services for customers provided by the energy industry;
- efficiency in the electricity industry and the incentive for efficient long-term investment from both incumbent and new entrant retailers
- competitive market conduct where customers are able to choose their retailer and the best product suited to them;
- a reduction in the complexity and cost of regulating the energy market.

After a one-off year one adjustment, it would then be possible to adopt an average price path approach as suggested by the Tribunal. This, as Origin has stated in previous submissions, would allow the Tribunal to adopt a light handed approach to regulation and let market forces self regulate a competitive market.

Entry by new retailers to the NSW electricity market and their contribution to increasing competition in the market is dependent on prices being cost reflective (including commercially acceptable returns). Participation in this market is likely to remain negligible whilst regulated prices remain below cost reflective levels.

## **4. Barriers to Entry**

As stated in the introduction to this paper Origin is national retailer and as such seeks to become an active participant in competitive gas and electricity markets. In doing this Origin seeks competitive markets that are fully transparent, can offer the opportunity to earn a reasonable commercial rate of return, and can provide a level playing field for all market participants where significant barrier to entry do not exist.

Despite this desire and FRC existing in NSW since 1 January 2002 Origin has not entered into the small electricity market in NSW (apart from a small number of specialist products). Part of the reason for this is reflected in a central theme of IPART's draft determination, that is, the multiple layers of barriers to entry that it cements for second tier or competitive retailers attempting to enter the electricity market in NSW. The fact that there has only been 2% churn, to another retailer, indicates that other potential market entrants have a similar view of the market to Origin. Should the Tribunal go ahead with its draft decision Origin firmly believes that this position will not change significantly until at least the end of the next determination in 2007/08.

### **4.1 Risk**

The Tribunal's analysis and benchmark outcomes are focussed entirely on the cost structure of incumbent businesses that have the advantage of arrangements such as the ETEF. The Tribunal fails to take into account that ETEF is only available to incumbent retailers. This has resulted in the market risks of second tier retailers and recovery of their customer acquisition costs being ignored in the Tribunal's decision. The Tribunal has not reflected risks associated with wholesale electricity purchases in its allowances for energy costs or in the net margins. The direct impact of this is the creation of a barrier to entry for new market entrants.

### *LRMC*

LRMC does not reflect the full cost of energy purchases. If IPART are to use LRMC as the benchmark for wholesale electricity purchases then there should be an allowance made for energy purchase risk or a higher retail margin to account for this risk.

### *ETEF*

If IPART are to use ETEF as the benchmark for wholesale electricity purchases then it must be recognised that ETEF is not available to new entrants. New entrants need to contract this risk and therefore should be allowed a higher retail margin or risk premium to allow for this.

The draft determination calculates benchmark wholesale electricity prices based on LRMC but does not allow for energy purchase risk or a higher retail margin (similar to the allowance by CRA of 5% to 8% in Victoria<sup>6</sup>). The Tribunal states that this is justified because retailers have access to ETEF which eliminates energy purchase risk (ETEF does not exist in Victoria). What the draft decision fails to take into account however is that only the incumbent NSW retailers have access to ETEF. This means that incumbent retailers are likely to have a different view of net margin than new entrant retailers - who will see the additional energy purchase risk cost. Clearly this is not a level playing field for competition.

Further Origin maintains it's already stated position to the Tribunal that continuing government intervention in the form of the Electricity Tariff Equalisation Fund (ETEF) will continue to stifle the development of effective competition in the NSW market.

## **4.2 Retail Net Margin**

Origin contended in it's submission on the NERA report that the net retail margin for operating an electricity retailing business should be sufficient to cover all applicable costs, including such costs as bad debts, credit, depreciation and amortisation, marketing and advertising, legal services, and a return on capital employed.

Origin believes that the 2% retail net margin (before interest and tax) proposed by the draft determination is insufficient to encourage competition from new entrants in the NSW electricity market.

Origin is a commercial enterprise that has a responsibility to deliver appropriate returns on investment to its equity shareholders. The Tribunal states that 'profit margin represents the reward to investors for committing capital to a business'. Origin strongly believes that 2% net margin, in and of itself, is not a sufficient return for a commercial enterprise to invest in the NSW electricity. Further, the benchmarks set by the Tribunal and the associated additional risks faced by new entrants in the NSW electricity market mean that this low margin not only acts as a disincentive to entry but becomes a significant barrier to entry for any new entrants.

Origin notes that the Tribunal has not referred to Origin's or any other new entrant's submission on margin but instead referenced the two lowest benchmarks suggested by incumbent retailers<sup>7</sup> who are not subject to barriers to entry. As government owned

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<sup>6</sup> Gas and Electricity Tariffs 2004, 'Charles Rivers Associates' report for Department of Infrastructure, December 2003.

<sup>7</sup> IPART, Review of Regulated Electricity Prices to 2007, Draft Report and Draft Determination, pg 44.

network stapled entities some companies may view retail net margin in a different commercial light.

The Tribunal contrasts this low retail margin (2%) as being in part justified (the other reason being no allowance for headroom) by the existence of ETEF in NSW (as opposed to Victoria where CRA has recommended margins of between 5% & 8%). However the ETEF fund only applies to incumbent retailers meaning higher risks for new entrants to the NSW market.

Together these factors lead to low retail margin becoming defined as a significant barrier to entry for new entrants to the NSW small electricity market.

Such barriers to entry are likely to prolong a dearth of investment in the NSW electricity market and delay the development of a functioning competitive broad based mass market until at least the start of the next determination.

Origin urges the Tribunal to allow for an appropriate rate of return to encourage competing retailers to attract small retail customers away from the regulated price. Origin re-iterates it's previously stated position that a minimum retail margin (EBIT/Revenue) of 5 per cent is necessary for competing retailers to enter the electricity market in NSW.

#### 4.3 Retail Costs

The Tribunal has set retail operating costs at \$65 including FRC. The Tribunal's number is based on the NERA report which quoted a range of \$50 to \$80 allowing *'most retailers...recover reasonable costs'*.<sup>8</sup>

The Tribunal states that NERA's number is calculated on an analysis of each retailer's costs as well as referencing benchmarks in other jurisdictions. However the Tribunal does not acknowledge NERA's stated limitations in carrying out this review. The NERA report stated that because the information available from retailers was limited their analysis on retail costs was heavily reliant on external benchmarks. Origin and a number of other respondents to NERA's report pointed out that NERA's analysis did not take into account many of the most appropriate benchmarks available to it (most notably CRA's figure of \$92 for 2004 in Victoria<sup>9</sup>).

The draft determination acknowledges that the proposed benchmark was considerably lower than other jurisdictions but then rejects benchmarking as being *'inconsistent with setting efficient costs'*<sup>10</sup>. Instead the Tribunal refers to NERA's analysis as the basis for setting the draft decision benchmark.

If this is the case then the analysis that underlies the NERA investigation must be accurate, transparent, relevant and properly defined. NERA themselves have said that

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<sup>8</sup> IPART, Review of Regulated Electricity Prices to 2007, Draft Report and Draft Determination, pg 41.

<sup>9</sup> Gas and Electricity Tariffs 2004, 'Charles Rivers Associates' report for Department of Infrastructure, December 2003.

<sup>10</sup> IPART, Review of Regulated Electricity Prices to 2007, Draft Report and Draft Determination, pg 41.



the <sup>11</sup> nature of the information provided by retailers allows only limited investigation into the reasonableness of projected costs.

#### 4.4 Approach to Regulation

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.

Despite this however the draft determination further constrains the move to cost reflectivity by:

- placing limits on tariff increases per annum,
- prescribing target tariffs,
- placing limits on the retail component of the tariff,
- placing constraints on the average increase for any customer in any one year,
- placing limits on the increase in any one customer's bill,
- allowing no increase in tariffs deemed to be over-recovering (on IPART 's benchmarks),
- placing limits on the fixed and variable retail components.

In addition to the above the Tribunal has rejected the need for an allowance for product innovation (Green Premium etc) stating that there is enough scope for product innovation within the existing benchmarks.

While full pass through of the network "N" component has been allowed the approach taken to the retail component "R" has been highly prescriptive. Origin believes that this approach is in no way consistent with light handed regulation. Indeed it appears that the tariff approach being proposed is even more complex and prescriptive than the last determination. Origin Energy urges the Tribunal to re-consider the extent of the regulation it has proposed in the draft determination.

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 believes that the constraints that the Tribunal has proposed in it's cannot support a timely move to effective competition and an associated shift to truly light handed regulation.

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<sup>11</sup> NERA Report to IPART NSW, February 2004, Pg 6

## 5. Summary

Origin refers to the Minister's Terms of Reference<sup>12</sup> (TOR) for the Tribunal's investigation and would like to point out that the Tribunal, under the TOR, must:

- take account of the consumer's ability to adjust to price changes,
- ensure that revenue is at an adequate level to cover costs,
- insure that the level of regulated retail prices is at a level to encourage new entry into the retail sector,
- consider the Government's 'policy aim of reducing customers' reliance on regulated prices.

Origin believes that IPART has taken a very narrow definition of customer's ability to adjust to costs. The draft decision limits the retail component of the tariff to CPI plus minimum increases for the duration of the next determination.

In doing this, by the third year of the next determination, there will still not be full cost reflectivity in the NSE electricity market - even using the Draft Decision's low benchmarks. Based on alternative benchmarks proposed by Origin Energy, other retailers and regulators in other states, the level of under-recovery would be substantial in year 3.

The terms of reference further notes that the government's policy aim is to reduce customers' reliance on regulated prices which will facilitate a move to light handed regulation. Origin is concerned that the Tribunal's determination sets 'efficient benchmarks' that are too low, creating and maintaining several barriers to entry. In addition new entrants are not seeing a market where there is a level playing field - where incumbent players have advantages such as ETEF. The result of these factors is little incentive for new entrants to enter the NSW small consumer electricity market.

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<sup>12</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.*