



**Review of Regulated Retail
Tariffs and Charges for
Electricity 2007-2010**

**Response to consultant's reports
- Energy costs & Mass market
new entrant retail costs and
retail margin**

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1. Introduction / Overview

Origin Energy Limited (Origin) welcomes this opportunity to respond to Frontier Economics' (Frontier's) reports to the Independent Pricing and Regulatory Tribunal (IPART)-'Energy costs' and 'Mass market new entrant retail costs and retail margin'.

Origin has operated in NSW in recent years and we continue to grow our customer base in that market. As such we are extremely well placed to comment on Frontier's report from the perspective of a mass market new entrant retailer within NSW. Our substantial experience in the Victorian and South Australian markets also enables us to comment on customer acquisition costs and the resultant impact on customer life cycle.

In assessing Frontier's report, it is essential to revisit the key requirements of the Terms of Reference (ToR) set by the Minister. In our view, the critical requirements for the current determination include:

- The Government's policy aim of reducing customers' reliance on regulated prices;
- The effect of IPART's determination on competition in the retail electricity market;
- Ensuring regulated tariffs cover the costs of supply and are at cost-reflective levels for all small retail customers by 30 June 2010;
- These costs are to be assessed from the perspective of:
 - A new entrant generation (energy costs), and
 - A mass market new entrant (MMNE) for retail operating costs and for retail margin.

Origin's view is that the Frontier reports raise a number of concerns in terms of consistency with the ToR. We detail these concerns in the body of this document but they can be summarised as follows:

Energy Costs:

- We support the use of the long run marginal cost of generation but do not believe that the current settings contained in the Frontier report are consistent with the levels required to encourage investment in generation;
- The lack of relativity across the regulated customer bases, particularly between Energy Australia and Integral Energy, is indicative of potential abnormalities in the underlying load profile data. We strongly recommend that these assumptions be revisited;
- The use of the ACIL Tasman data to support the analysis compromises the outcomes from the LRMC modelling and should be reviewed;
- Energy purchase costs need to appropriately reflect the level of risk faced by a mass market new entrant retailer.

Retail Operating Costs:

- Frontier's analysis returns lower retail operating costs than any other competitive jurisdiction in Australia. Readily available regulatory benchmarks in Victoria and South Australia indicate efficient retail operating costs (excluding customer acquisition costs) in the order of \$95 per customer.
- Frontier's conclusions are entirely inconsistent with the ToR which explicitly refers to mass market new entrant retail costs. Frontier has based its conclusions on incumbent retailer costs and each of these businesses is attached to a network business. This increases the likelihood of cross business subsidisation in the underlying data.

Customer Acquisition Costs:

- Origin broadly agrees with the customer acquisition costs contained in the Frontier report;
- However, Origin believes that the customer amortisation period is overstated. With appropriate retail price policy settings there is no reason why customer churn rates in NSW should be lower than in Victoria and South Australia. These markets would suggest an expected customer amortisation period in the order of 3 to 4 years.

If IPART is to effectively support the Minister's requirements in the TOR, then serious consideration will have to be given to the issues raised above. We also note that the NSW Government is a signatory to the national reform agenda, including the Australian Energy Market Agreement¹. This reform agenda clearly sets out the principles that are in turn largely captured in the Minister's TOR. It is critical that this study provides valid input into the current Determination such that NSW's energy markets align with national commitments.

2. Long run marginal cost of electricity generation

In broad terms Origin is supportive of the use of the long run marginal cost of generation to support the Tribunal's objectives. However we do note that there are a number of different approaches to determining an appropriate allowance for electricity purchase costs within retail tariff structures. As such we endorse the view that the outcomes from Frontier's modelling be assessed against other approaches to ensure that the results appropriately reflect the cost facing retailers. To this end we are concerned by three aspects of the results from Frontier's modelling:

- The use of the ACIL Tasman estimates for capital and other costs supporting generation investment;
- The lack of relativity between underlying energy costs across different franchise areas. In particular, the similarity between the outcomes modelled for Energy Australia and Integral Energy regulated customers is an extremely surprising outcome;
- Results across all regulated customer bases are surprisingly low and not consistent with our view of energy prices required to support generation investment.

In respect of the lower than expected energy costs and the surprisingly low differential in costs between incumbents, we believe that this may partly be the result of the way the controlled load has been incorporated in the load shapes provided to Frontier. This has the effect of dampening the peakiness of the profile used in the modelling, and therefore underestimates the true cost of hedging the underlying load shape for a mass market new entrant retailer. For example, significant fuel substitution occurs in metropolitan Sydney through the use of natural gas for hot water heating.

Furthermore, we consider that the controlled/non-controlled split between incumbent retailers has not been represented correctly, which may therefore have dampened the peakiness of Integral Energy's load shape relative to that of Energy Australia's. This issue may have occurred because of different data provided by each of these incumbents in response to a request for information.

¹ For example, Australian Energy Market Agreement (as amended in 2006); sections 14.10 to 14.16.

Our concern is exacerbated by the lack of transparency in the provision of data applied by Frontier in their calculations, which Origin considers a critical input in the determination of energy purchasing costs.

We strongly recommend further analysis be undertaken of the relevant load shapes, particularly as they relate to a mass market new entrant retail (i.e. the NSLP as applied by NEMMCO) before it is used to derive energy purchase costs. Without such a review, Origin believes that the modelling of energy purchasing costs will be deficient to the extent they fail to achieve the ToR objectives, namely, to estimate the energy procurement costs of a mass market new entrant retailer.

We also note that Frontier has used ACIL Tasman estimates for capital and other costs underpinning its LRMC figures: for instance, it assumes the capital cost for CCGT is \$850kw. However, our own estimates based on the latest advice from contractors, BRW consulting and others, places the cost of a new 400MW CCGT at around \$1200kw. We believe the costs (labour and steel costs) have risen substantially since the ACIL report was completed and we urge IPART to obtain a broader independent review of the cost assumptions underpinning the Frontier analysis.

Origin also notes that ACIL uses a real post tax rate of 6.31 per cent to underpin its WACC. This contrasts to the real return proposed by IES in the 2004 determination of 9.5 per cent. We strongly concur with the IES assessment. While the WACC calculated by ACIL Tasman provides a reasonable estimate, the important point to note is that the WACC does not determine whether the investment takes place; rather, it is the hurdle rate generally a few percentage points above the WACC which in fact provides the essential decision criterion. This occurs for two reasons:

- First, the parameters, such as asset beta and market risk premium, underpinning WACC are highly uncertain (because they reflect expectations). The WACC for particular projects tends, therefore, to be adjusted upwards in order to reflect the uncertainty surrounding the extent to which projects are subject to systematic risk (that is, the extent to which the returns of particular projects are sensitive to economy wide factors that cannot be diversified away).
- Second, even with perfect foresight, the WACC really only recovers the minimum opportunity cost of investing in that asset. That is, the value that leaves the shareholder just indifferent between investing in that particular asset or the next best alternative. To remove this indifference between investing in two asset alternatives will require that additional value is created by the particular investment option chosen: a return over and above the WACC.

For these reasons, most investors in generation assets generally require an expected return (hurdle rate) a number of percentage points above the traditional WACC. This should be reflected in the LRMC calculations. We therefore strongly support a real allowed rate of return closer to that recommended by IES in the 2004 consultation, which is closer to what Origin itself would require before undertaking any investment in generation projects.

3. Market based costs

3.1 Contracting approach

In assessing the wholesale purchase costs, Origin does not have any in principle concerns with the portfolio contracting approach adopted by Frontier. However little detail has been provided on what contract combinations might be considered “conservative” or, alternatively, “risk taking”. While the spectrum of combinations on the risk return frontier is useful for illustrative purposes, only the conservative

point, given the fundamental uncertainties in the calculations, should be used. However, it is also unclear what Frontier considers to be a conservative portfolio of contracts or the assumptions on which it arrives at that particular combination. This needs to be opened to further scrutiny; as the resultant estimates appear to be low in our view.

In our original submission we noted that it is likely that most prudent retailers are likely to hedge their peak loads at close to 100 per cent of a 1 in 10 year demand (based on NEMMCO's forecasts). The reason for this is the impossibility of accurately forecasting the future peakiness of load (the past is not of itself a reliable guide) and the asymmetric risk associated with making such errors. With pool price and extreme demands being highly correlated, the potential costs of under-contracting are significantly higher than over contracting. As a consequence, to the extent that Frontier uses a load profile with a higher probability of exceedence (such as a 1 in 2 year demand) this will significantly lower the assumed cost of hedging relative to the actual prudent cost incurred by most retailers. That is, it would assume the risk return frontier is lower than what it actually is, given a sensible consideration of all of the risks involved.

It is also critical to recognise the estimation risk inherent in using forward looking contract prices to assess wholesale purchase costs (one of the reasons we tend to prefer the LRMC approach). While Frontier has attempted to address this by using its own forecasts combined with views of other retailers, these forecasts nevertheless reflect a snapshot based on the best available information at that time. However, as recent events in the NEM have demonstrated, a couple of days of higher than expected demand, combined with other unforeseen events such as transmission or generator outages, can quickly change market expectations and substantially lift the forward price curve in a short space of time (for example from October last year to January this year forward looking swap prices have increased up to \$5 in QLD). To the extent a number of these unforeseen events occur, or any other new information comes to light that indicates that demand growth or load volatility may have been underestimated, this could lead to a collective rush to more contracting, rapidly pushing up contract prices and creating the potential for a liquidity crisis.

Rapid movements in contract prices and wholesale market liquidity therefore present significant risk to retailers in the face of a regulated customer base with fixed tariffs. We seek clarity to the extent to which the Frontier modelling has taken these risks into account by providing for an "estimation" or "liquidity" risk premium in the risk return frontier.

3.2 Impact of market developments on the load profile

In sourcing data from incumbents, it is not clear the extent to which Frontier has allowed for fundamental changes in the load profiles for which a MMNE will be expected to hedge against. A number of NSW distributors, most notably EnergyAustralia, have engaged in a program of rolling out interval meters within their networks on customers consuming more than 15,000kWh per annum. A substantial number of such meters have already been deployed, and Origin considers that to the extent they are peeled off the Net System Load Profile (NSLP), a MMNE is likely to face a very different load profile from that used to forecast energy costs in the consultation paper. This is because the load factor associated with these larger mass market consumers is unlikely to be comparable to customers falling below the 15MWh per annum point.

Origin would recommend that the changing shape of the residual NSLP over the determination period be considered and the costs of hedging such a changing NSLP be compensated for in an appropriate manner in the estimation of energy procurement costs.

4. Retail Operating Costs

Origin is concerned by the approach taken by Frontier with respect to estimating Retail operating costs. The ToR provide clear guidance to the Tribunal that Retail operating costs must be considered in the context of a mass market new entrant retailer. However the proposed allowance of \$60-\$80 per customer has been based entirely on the cost structure of incumbent retailers and is therefore entirely inconsistent with the ToR.

We are also concerned that the incumbent retailers are stapled to a network business which creates difficulties in determining underlying retail costs, despite ring-fencing obligations. While Frontier has assessed the reasonableness of the outcome from their study for consistency they note that “the clear exception is billing and revenue collection costs for which there is a wide range across retailers” (p22). Billing and collection costs are the areas in which it would be expected that there is the potential for cross subsidy across a stapled retail and network business. A mass market new entrant retailer does not have the luxury of recovering part of their billing and associated expenses from another part of their business; retail tariff settings must allow for the full recovery of underlying costs.

We note that the request for information was limited to:

- Call centre costs;
- Customer information costs;
- Corporate overhead costs;
- Regulatory compliance costs;
- Marketing costs;
- Billing and collection costs;

As noted in our response to the issues paper, retail operating costs also need to provide recovery for bad debt expense and also the infrastructure costs of trading activities. Bad and doubtful debt provisioning is clearly a retail operating cost which needs to be recovered from retail tariffs. Our experience in other markets also suggests that mass market new entrant retailers are exposed to a greater level of bad debts than faced by incumbent retailers. The recovery of final debt from customers who churn is problematic due to a lack of understanding from customers to settle the final account and/or an unwillingness to pay.

Similarly, allowance for the system and personnel costs associated with energy procurement needs to be allowed for in the retail operating costs. While the underlying purchase cost and risk premiums are included in the energy component, the infrastructure required to support procurement and trading activities needs to be included in the retail costs. This is a principle which has been recognised in other jurisdictions.

Frontier has benchmarked its results for reasonableness extensively against the UK market. We strongly suggest that the Victorian and South Australian markets represent significantly more relevant markets for such benchmarking. The customer behavioural characteristics are more aligned to that likely to be expected in the NSW market and the labour market and associated costs are significantly better aligned. Regulatory reviews in both of those markets estimate retail costs to be in the order of \$95 per customer. This cost is exclusive of customer acquisition costs and we believe that this is the range that the Tribunal must consider in order to fulfil its requirements under the ToR.

5. Acquisition costs

We note that the Tribunal seeks to make an assessment of customer acquisition costs as part of its deliberations on retail pricing. We also note that these costs are explicitly beyond the scope of retail operating costs considered in other jurisdictions.

In broad terms we agree with the calculation of customer acquisition costs contained in the Frontier report. However we believe that the customer amortisation periods do not adequately reflect the expected life of a customer in a competitive market. With the appropriate retail price policy settings there is no reason to believe that the customer churn rate in NSW would not be any less than the churn rates in Victoria and South Australia. Customer churn rates in those markets are currently in the range of 20 to 25 per cent, implying an average customer life of 4 to 5 years.

It should be noted that reported churn rates reflect the entire retail market. A proportion of the incumbent's customer base does not actively participate in the competitive market. As such, churn rates for the customers who mass market new entrant retailers are targeting (and on whom customer acquisition costs are based) are likely to be higher than the reported market churn rates. Our experience in the NSW market indicates that a customer life cycle of 3 to 4 years is consistent with the aspirations of a mass market new entrant retailer.

We also note that Frontier assumes that customer acquisition costs will remain relatively flat over the determination period. We would point out that regulatory decisions have the capacity to impact the customer acquisition cost. The recent introduction of the Commonwealth's "Do Not Call" Register has the potential to impact a sales channel such as outbound telemarketing. The absence of such a channel is likely to direct more sales activity to more expensive channels such as door to door sales. This has the capacity to place more upward pressure on customer acquisition costs during the determination period, and we consider this a likely outcome over the determination period.