



15 April 2009

Review of market-based electricity purchase cost allowance
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

By email: ipart@ipart.nsw.gov.au

Dear Sir

ELECTRICITY PURCHASE COST ALLOWANCE - 2009 REVIEW

Origin Energy (Origin) is a second tier retailer supplying both electricity and gas to small and large customers in the New South Wales market. Origin welcomes the opportunity to respond to the draft report of the Market-based electricity purchase cost allowance 2009 review released by the Independent Pricing and Regulatory Tribunal (IPART) in March 2009.

Origin is pleased to see that the draft report has recognised the significant increases in wholesale energy costs that have been having a damaging impact on both retailers and competition in the New South Wales electricity market over recent years.

Origin notes that IPART had previously identified moving retail prices to cost reflective levels by the 2009-10 tariff year as an objective of its 2007 Determination. The draft increase in retail price moves electricity pricing towards this objective but it is apparent that the current regulatory framework will inhibit the reaching of this objective. Origin has therefore taken this opportunity to highlight the broad changes necessary for the framework to provide a fully competitive energy market.

Given this is the last year of the three year pricing regime, and the year in which retail prices are intended to reach cost reflective levels from a new entrant perspective, it is disappointing that the only element of the determination that is subject to review is the wholesale energy costs.

Origin understands that wholesale energy costs were the only parameter that was identified by IPART for an annual review. Nevertheless, the limitations of this are apparent as the review is unable to consider the totality of the retail price even though the direction set by the Minister in 2006 for IPART was quite clear in terms of the objectives of establishing cost reflective pricing that:

"The determination should ensure that...regulated retail tariffs and regulated retail charges are at cost reflective levels (including all the costs listed above) for all small retail customers by 30 June 2010"¹.

¹ *Terms of Reference - on Regulated Retail Tariffs and Regulated Retail Charges to apply between 1 July 2007 and 30 June 2010, July 2006*

In Origin's view there are a number of observable facts about the NSW competitive market in 2008-09 that should have prompted a review of the approach adopted by IPART. They are the:

- continued low level of customer churn compared to all other jurisdictions;
- reversion of customers to regulated retail tariffs; and
- significant discrepancy between wholesale prices and the allowed energy prices.

These outcomes are in contrast to the stated objectives of the Minister to support a competitive market and minimise the number of customers on standing tariffs.

Moreover, Origin is concerned with the lack of tariff reform of those standing tariffs. The 2007 determination provided guidance to the incumbent retailers that all standing tariffs should move towards cost reflectivity and indeed loosened the side-constraints to achieve this end. Yet many retail tariffs (as at 2008-09) are clearly below cost reflective levels. Origin urges IPART to investigate this specific issue prior to finalising 2009-10 retail tariffs and promote restructuring of tariffs in accordance with the original intentions of the 2007 Determination.

Careful consideration of these matters is essential to comply with the government's commitments to competition in retail markets. It is also a key component of the NSW's government's reform program for the electricity industry as it impacts on decisions through the investment value chain from generation to retailing.

Moreover, with the likely advent in July 2010 of a Carbon Pollution Reduction Scheme (CPRS) based on a cap and trade model, together with the expanded Renewable Energy Target (RET), retail pricing is facing an era of wholesale price increases, uncertainty and complexity. It is essential in this environment that the "basic" retail pricing principles and reform of prices are soundly established prior to the introduction of the CPRS.

2009 Regulated Retail Price

Origin supports the proposed retail price increases as a positive step for future retail competition in New South Wales.

Origin advocates the basic tenet that to achieve sustainable efficient markets, retail pricing must be sustained at cost reflective levels and believes that price deregulation is the only truly effective manner for accomplishing this. However, as retail prices in New South Wales remain regulated, the annual review process outlined in the 2007 IPART determination has provided some support of this principle.

The three year price path determined by IPART in 2007 was to facilitate a move to cost reflective pricing however, there have been shortcomings to the approach which made the present determination process unworkable and not a suitable formula for going forward.

One issue is the inability of a three year price path to effectively track potential volatility in cost structures. As noted by Frontier Economics in the Public Forum², it is always difficult for a regulator to set regulated prices in a volatile market. This was born out in the 2008 annual review when, despite the volatile wholesale market prices, the limits

² IPART, Public Forum, 2009 Review of Market-based Electricity Purchase Cost Allowance held on 19 March 2009 - Transcript.

placed on the review process (that is, the 10% threshold) were not met. This prevented the full cost increases faced by retailers from being picked up in the retail price. The ramifications to the market were that second tier retailers, which did not have the protection from Electricity Tariff Equalisation Fund (EETF), suffered a loss in retail margin and consequently, reduced their market activity.

Having lost the opportunity to obtain a reasonable margin through the 2008-09 retail prices, the proposed 2009 price increase re-establishes retailers' retail margin going forward but does not reimburse retailers for these past losses. Accordingly, although the methodology may provide a possible cost reflective outcome for 2009-10, the review process still affords a lack of certainty and introduces regulatory risk for second tier retailers and host retailers absent EETF.

The 2009 annual review process has picked up an increase in wholesale price movements - a partially effective safety measure to alleviate price risk for retailers going forward and therefore assists in moving the retail prices towards sustainable levels. However, as noted above, the shortcomings with the current process do not compensate retailers for lost retail margins nor for the management of the volatile wholesale prices for the past year.

Origin notes that the IPART draft paper acknowledges the proposed increase to the regulated retail prices for New South Wales customers at 1 July 2009 will be between 18 - 20 per cent but has commented that such high increases are not welcomed.

Origin believes, despite the concerns expressed by IPART on the size of the proposed retail price increase, that the proposed price increase is justifiable (and overdue) and takes proper account of the main cost increases expected by retailers for 2009-10. However, it is important to emphasise that only 5 - 6 per cent of the proposed retail price increase is attributable to the 2009 review³.

The review process, as outlined in the 2007 Determination was specifically designed to ensure the retail prices meet cost reflective levels by the tariff year 2009-10. Therefore, despite the size of the proposed increase as a whole, the 2009 price increase will only see the retail component of the tariffs move toward cost reflective levels by the 2009-10 tariff year.

It is also important to flag that network costs account for a substantial amount of the proposed retail price increase. Accordingly, when referring to price increases as a result of the annual review, Origin believes it is logical to separate the increases to customers based upon the retail component (by virtue of the 2009 Review) and the network component. IPART made a commitment in its price setting process to have a full pass through of network charges which will see a continued alignment of network charge increases. As network charges are set through a separate regulatory process undertaken by the Australian Energy Regulator and treated as a direct pass through to retail customers, it is only the 5 - 6 per cent retail component increase that will influence future retail competition.

A further limitation of the current annual review process is that it does not capture other cost increases. For instance, the NSW Government intends to introduce a new energy

³ This includes the established transitional price path increases for 2009-10 period determined in the 2007 IPART Determination of around 1-3 per cent depending on the retailer.

efficiency scheme in July 2009⁴, and potentially, a new solar photo-voltaic feed-in tariff. Both schemes add to retailers' costs to supply, yet are not covered by the review process.

Furthermore, even the review of wholesale price changes itself is restrained and does not capture the impact of greenhouse policies on the energy market. For example, Frontier note that increases are being made to the renewable energy targets for 2010 but no changes have been incorporated into their modelling to account for this additional cost.

Limitations of Current Regulated Retail Tariffs

Two key indicators within the retail energy market suggest that current retail prices are below sustainable levels and support the retail price increases proposed by the 2009 review.

The first of these is the volume and number of customers on regulated standing contract tariffs. The report by Frontier Economics⁵ has illustrated this by consideration of the change in the percentage of load under ETEF⁶ since 2001. The 2008 share would indicate an increasing number of customers reverting to the standing contract tariff, reflecting in turn a lack of ability of retailers (including incumbent retailers) to compete with the standing price backed by ETEF.

Although this conclusion was qualified by reference to possible changes in average load due to temperature, Origin believes the hypothesis can be readily tested by reference to the number of customers on standing contracts (data readily available to IPART). If the number of customers on standing contracts is increasing (and Origin has reason to believe it is) then this strongly indicates a fundamental issue with the current determination that needs to be addressed in the 2009-10 decision.

The aggregate ETEF customers for the calendar years 2007 and 2008 show a rising number of ETEF customers from mid-2008 around the time the 2007 Determination was implemented. As noted by Frontier Economics, this suggests customers are returning to regulated contracts.

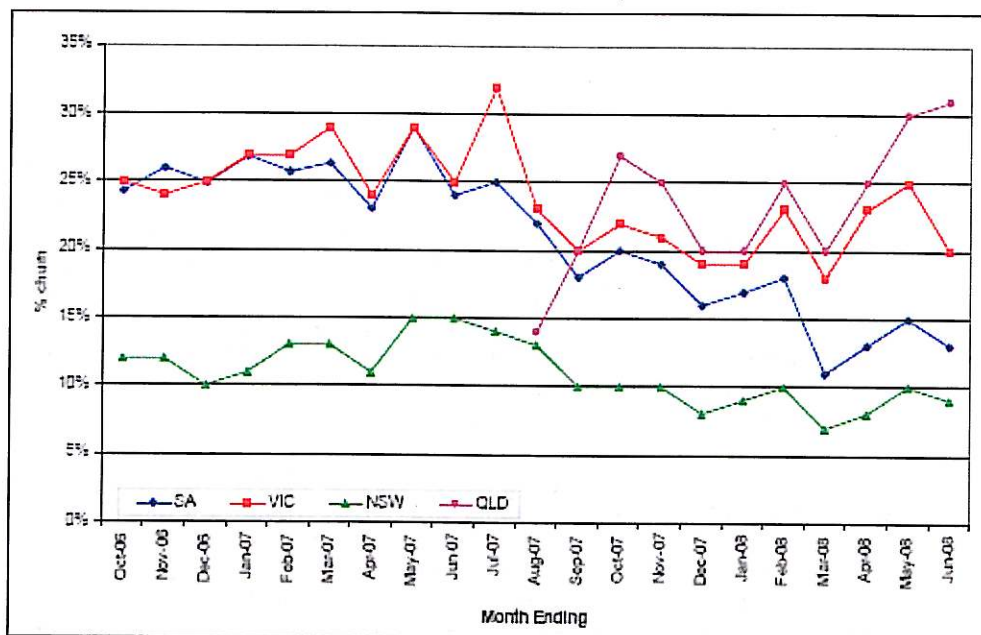
In addition to this, the churn rate for New South Wales in the same period hovers around 10 per cent, arguably trending lower over 2008. Figure 1 shows the annualised customer switching rates for New South Wales, Victoria, Queensland and South Australia. This figure clearly suggests the active marketing of market contracts in New South Wales is not as vigorous as the activity in other jurisdictions where churn rates average between 20-25 per cent.

⁴ While initially this Scheme may be based on the current NGAC Scheme, it is expected to transform through the 2009-10 year.

⁵ Frontier, *Annual energy cost review: Final Report*, February 2009

⁶ The ETEF Scheme is only available to customers on standing contracts. When a customer moves to a market contract, their retailer (even if it is the same retailer) cannot supply them under the ETEF agreement but must separately contract their load with a generator or other third party.

Figure 1: NEMMCO Annualised Customer Switching



Source: 2007-08 Annual Performance Report Energy Retail Market: ESCOSA 2008

In order to encourage more participation in the NSW retail market and to avoid retail market participants exiting the New South Wales market, a more flexible approach to price regulation in NSW must be considered.

Future of regulated retail pricing

Origin takes the view if there are no significant barriers to entry and customers are free to make an adequately informed decision about their choice of retailer, price setting should be left to the market, this is particularly true for changing cost environments. However, the NSW Government has appeared to commit to maintaining retail price regulation for current eligible customers until at least 2013⁷. In which case, Origin agrees with the view espoused by the NSW Government⁸ that a fully cost reflective retail tariff is essential to support a proper functioning market.

In terms of the changing cost environment in energy markets, Frontier Economics in its expert report identified external influences that have affected the wholesale energy cost in the two year period since the 2007 IPART determination. Those influences by their nature have imposed an element of uncertainty upon future wholesale energy costs and include drought conditions, industry changes, greenhouse policies and the impact of ETEF. The energy market continues to be plagued by these uncertainties which will continue to affect future energy prices.

Accordingly, some stringent regulatory principles must be designed and adhered to, to ensure the NSW energy market functions appropriately.

⁷ NSW Government Energy Reform Strategy paper, March 2009

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Whilst Origin believes the removal of price regulation is the best approach in a market faced with uncertain and volatile price movements, where price regulation is set to continue into the carbon constrained future there are a number of key regulatory principles to ensure a price that will best replicate an efficient retail price:

1. Cost reflective pricing structures

Pricing determinations must achieve cost reflective pricing by including direct cost pass through of network charges and allowance for all external factors influencing wholesale energy costs. They must also include an appropriate recognition of the cost of risk and risk management. These considerations are particularly important given the imminent introduction of CPRS and expanded RET. Origin believes the proposed changes to the Australian Energy Market Agreement (AEMA) as recommended by the Ministerial Council of Energy (MCE) are an important step to a consistent approach to retail pricing across all jurisdictions and expects IPART to acknowledge these agreements even in its current considerations.

Origin understands and supports those aspects of the NSW energy reform strategy that provide for a robust consumer protection framework and ongoing government support for customers with difficulties paying energy bills. Whilst the energy market struggles with the volatility and changing dynamic associated with CPRS, the retail market must be assured of regulatory certainty and that social welfare issues are appropriately addressed through government incentives rather than indirectly through retail price restrictions.

2. Transparent tariff methodology

The methodology adopted to calculate annual price changes must provide for an open and transparent process. Such a process is to adequately consider stakeholder input and must be consistently applied throughout the determination period. Price regulation at a State level could be more efficient and better served by more consistent regulatory application of retail cost structures.

3. Limited duration or flexible price determinations

Retail pricing methodologies rely upon assumptions regarding future cost inputs which can only be a best guess of a future efficient price. Future costs are particularly unreliable in volatile markets where forecasting of efficient costs becomes more problematic the longer the regulatory period. As such the duration of the regulatory period can have significant impacts upon a retailers cost structures. Given the outcome of the current IPART review process, it is clear a three year period is subject to these problems, even with an annual review of the wholesale energy costs. Consequently, Origin supports shorter regulatory periods or alternatively, slightly longer periods with more flexible arrangements providing for cost movements.

4. Regulatory Certainty

A significant risk faced by retailers in regulated environments is regulatory uncertainty.

IPART has indicated its reluctance to see the retail price move by such an increase, however recognises its commitment to adhere to its regulatory contract as imported

into the IPART 2007 determination. Origin is encouraged by IPART's commitment to its 2007 Determination in the 2009-10 draft determination and considers this may provide retail market participants in New South Wales with improved confidence in the regulatory environment in NSW.

Origin considers that to date, at least, there has been a clear deficiency in the current determination period to achieve the objectives of promoting competition, encouraging a move away from standing offer tariffs and achieving broad ranging tariff structural reforms.

As part of the current determination, Origin therefore urges IPART to objectively consider these negative outcomes and the implications of these for setting regulated retail tariffs in 2009-10. The importance of establishing cost-reflective 2009-10 tariffs (the "base" year before the introduction of the CPRS) must not be underestimated.

Should you require further information regarding these issues, please do not hesitate to contact Beverley Hughson on (03) 9652 5702.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Duncan Permezel', with a stylized flourish at the end.

Duncan Permezel
Retail Executive Directions & Growth

