20 April 2016

Mr John Hindmarsh
Chief Executive Officer
Queensland Competition Authority
GPO Box 2257
Brisbane 4001

Email: electricity@qca.org.au

Dear Mr Hindmarsh

REGULATED RETAIL ELECTRICITY PRICES 2016-17 – DRAFT DETERMINATION

Origin Energy (Origin) appreciates the opportunity to comment on the Queensland Competition Authority's (QCA) Draft Determination on Regulated Retail Electricity Prices for 2016-17.

The QCA's determination of regulated prices for 2016-17 will only apply in the Ergon Energy distribution network as a result of the introduction of market monitoring in south east Queensland (SEQ) from 1 July 2016. As a result, Origin considers the QCA approach for this determination an important step towards putting in place the necessary pricing reforms to support a transition to full retail competition in the Ergon network.

Origin notes the QCA proposes a change in the methodology for determining retail costs and margin. Origin does have a concern that a retailers full costs of supplying electricity customers will not be fully recognised under this methodology. The QCA has chosen to benchmark retail costs against those of competitive retail market offers and they fail to recognise the costs of maintaining and supplying standard customers in Queensland. Further, the QCA has chosen not to determine a separate retail margin and rather the margin has been incorporated into the retail cost component.

Origin would expect retail operating costs (including customer acquisition and retention costs) and margin to be set separately to encourage new entrants, competition and business efficiencies in the Ergon network. If the retail cost component of each tariff is set below a retailers cost to serve, competition will stall and customers will not be offered price benefits or discounts. This is to the detriment of consumers.

Further, Origin does not agree with the proposed rebalancing of the fixed and variable components of the retail tariff. It does not reflect a true allocation of costs to customers in Queensland and it may lead to the cross subsidisation between customer segments as retailers attempt to recover fixed costs.

Origin has provided specific comments on the cost components of the QCA's Draft Decision below.

Pricing Framework and Network Costs

Origin recognises the constraints the QCA face in determining the pricing framework and the network cost components in the 2016-17 Determination given the terms of the delegation issued by the Minister for Energy. The delegation re-affirms the Government's commitment to the uniform

Origin Energy Retail Limited ABN •, 264-278 George Street Sydney NSW 2000
GPO Box 5376, Sydney NSW 2001• Telephone (02) 8345 5000 • Facsimile (02) 9252 9244 • www.originenergy.com.au

tariff policy and binds the QCA to base the network cost component on the level of Energex charges and structures for flat rate tariffs and Ergon structures for time-of-use tariffs.

While the Delegation requires the QCA to consider the pricing framework for 2016-17 only, Origin believes it is important for the QCA to acknowledge the draft recommendations of the Queensland Productivity Commissions (QPC) Electricity Pricing Inquiry in making its final decision.

With respect to regional Queensland, the QPC's Draft Report recognises that improving competition and outcomes cannot be achieved unless key barriers are removed[1].

Until retailers other than Ergon Energy can access the community service obligation (CSO) subsidy, competition will continue to be slow in regional areas. Therefore, moving towards a network-based CSO will allow all retailers to access the subsidised network prices and compete for regional customers. This provides the best means of delivering the goods and services that consumers want at prices that reflect efficient costs.

Complementing this reform should be the opportunity for customers to respond to price signals including, and in particular, those sent by the network business. The QCA could take incremental steps by calculating the network cost components based on Ergon's tariff structure with Energex's cost level over a period of time for flat tariffs. This approach would remove the outcome where customers face price signals that do not reflect the impact of their consumption and would therefore encourage efficient consumption and investment decisions to be made.

A move to align network prices with actual cost of supply will be compatible with the National Electricity Rules which requires network businesses to develop individual cost reflective tariffs.

Energy costs

As stated in previous submissions, it is Origin's view that the QCA's hedging based method does not appropriately reflect the dynamic of the wholesale market with respect to the relationship between contract and pool prices. Under the QCA's approach, the portfolio cost is at its lowest under a scenario when pool prices are at their highest and the supply demand balance is at its tightest; conversely, portfolio costs are at their highest under a situation when pool prices and demand are at their lowest. This approach has been taken by the QCA over the previous three years.

Our experience is that when the supply demand balance is tight, generators have more ability to price contracts at higher values to reflect the value of scarce capacity. Furthermore, we consider that historic practise demonstrates that when pool prices are high so too are contact prices.

As a result, we maintain our view that it is unrealistic to assume retailers will consistently be able to profit from buying an insurance product and that the higher the pool price scenario, the lower the wholesale energy cost. This would be the third consecutive year that the QCA's approach has assumed a positive payoff from 'insurance' products to the retailer.

Retail costs

The QCA has made the following draft decisions regarding retail costs for electricity customers in regional Queensland:

- estimated an average total retail cost allowances (inclusive of retail operating costs and margin) for residential and small business customer tariffs based on the benchmarking of market offers;

[1] Queensland Productivity Commission, *Electricity Pricing Inquiry – Draft Recommendations*, p147.

- adopted an average benchmark allocation between fixed and variable retail components which results in a rebalancing of the fixed and variable component of tariffs; and

- the 2015-16 benchmark retail costs should be applied without escalation in the 2016-17 notified prices.

As a consequence, Origin is concerned that the QCA's recommendations on retail costs do not adequately give full recognition of the actual costs of supplying electricity to standing contract customers in regional Queensland and each of these issues are addressed in turn below.

Retail Operating Costs (including CARC)

In Origin's submission to the QCA's Consultation Paper, we supported the use of a benchmark for determining the 2016-17 allowance.

However, in doing so, we do not support the benchmarking of market offers nor retail costs being bundled into one amount. Origin considers the benchmarking of market offers can be misleading as market offers represent only one element of the portfolio strategy of individual retailers. Retailer's structure prices in the various networks based on the market environment and their commercial objectives at a point in time.

Origin has concerns with the benchmarking of market offers as:

- the QCA has chosen to take an average, or mid-point, of retailer costs. Origin does not believe that this methodology is appropriate. The market offers selected by ACIL are the lowest in the market and thus there is a statistical bias. Costs to supply a standard customer in Ergon's region are likely to be higher given the geographical location of regional customers and specific standard supply requirements that apply to these customers (ie customers can revert to the standing offer at any time);

- ACIL has applied all conditional and unconditional discounts and product offers in the calculation of total electricity bills. These are likely to reflect the lowest cost to serve (ie customers honouring pay on time discounts, direct debit, using ebills) and are not reflective of the costs of supplying the market as a whole;

- The accuracy of the benchmarking approach hinges on ACIL's ability to estimate the wholesale costs of an efficient retailer. Estimating wholesale costs is broadly acknowledged as the most difficult and error prone element of retail price determinations. Notwithstanding some directional offsetting of error between wholesale and retail cost estimates it seems like an unnecessary complication to base an estimate of efficient operating costs upon a consultant's modelled wholesale prices;

- the benchmark reflects historical offers and prices of retailers rather than a forecast of future operating costs. For example, ACIL has indexed Victorian market prices by 6 months to present them on a similar basis as NSW, QLD and SA[2]. However, it fails to accurately recognise changes to the underlying network tariffs from 1 January 2016 which resulted in a shift of costs from the network component to the retail component. It further does not recognise the increased costs to retailers for more stringent hardship and disconnection policies that are being implemented in states such as Victoria later this year; and

- Queensland has not yet attracted the same intensity of competition as has been evident in other jurisdictions. Retail cost and margin allowances need to cover a retailer's risk

[2]ACIL Allen Consulting, *Regulated Retail Prices for 2016-17 – Estimating the Efficient Retailer Costs*, 17 March 2016, pvi.

weighted investment in order to entice them to the market. The benchmarking of market offers do not adequately incentivise retailers to make an investment in Queensland which is particularly true for retailers that have a higher cost to serve than the average. The QCA's approach effectively limits future market entry to retailers able to compete at below the cost to serve and margin requirement inferred from the average of the lowest priced market offers.

Origin believes the Draft Determination on retail costs is thus not representative of a retailer supplying customers in Queensland. Origin believes that the QCA should revert to the 2015-16 methodology and appropriately index the retail cost (including CARC) amount. Adopting the QCA's draft approach could lead to an under-recovery of retail costs by a retailer which could have a negative impact on competition and the willingness of retailers to engage in the market.

Retail Margin

The QCA has determined that the retail margin should form part of the retail cost elements and a separate retail margin should not be set.

Origin would highlight that the approach of including retail margin in retail costs has not been accepted nor adopted within any other jurisdictions. It has been widely recognised that each of these elements need to be estimated to provide an efficient build-up of costs for an energy retailer.

In a national electricity market, electricity retailers will seek markets where they can find the best value and if the risks are high and returns are low, their willingness to supply electricity customers in the Queensland market will decline. This will restrict a customers' ability to receive price and service benefits.

Origin thus, supports a retail margin based on a calculation of total costs as previously utilised by the QCA.

Fixed and variable Retail Cost Components

The QCA's draft decision is to use the allocation implied by the average fixed and variable retail cost allowances derived from ACIL's market offer observations.[3] This results in a rebalancing of the tariff components.

Origin does not support this approach and believes ACIL's analysis of the fixed and variable components of market offers is not representative of a retailer's true allocation of costs.

Origin submits that the fixed component of market offers in Victoria have most likely been artificially restrained in recent years to manage network price impacts to customers. There have been recent changes to the recovery of metering charges in Victoria leading to a marked increase in the fixed charge that would be too great to pass through within a year. In addition, New South Wales has been operating under a transitional pricing arrangement for the previous two years. Origin thus believes that the allocation of fixed and variable costs in 2015-16 market offers is thus not reflective of the efficient or likely design of retail tariffs in future years.

Further, the balancing of tariff components is reliant on the assumptions ACIL has made in relation to the average usage in each distribution area. This average usage influences the level of margin on the variable component on each of the tariffs. If there are any changes to the underlying average volumes utilised in each of the networks, the values can be influenced considerably.

In response to the tariff changes that occurred as part of the Tariff 1 freeze, the QCA has spent

[3] QCA, *Regulated retail electricity prices for 2016-17 – Draft Determination, March 2016*, p32.

three years moving retail tariffs to more cost reflective rates which has required uplifting of the fixed charges and the reducing of the variable charge in recognition of the large proportion of fixed charges that are incurred by retailers. Networks have also embarked on a similar process to rebalancing a greater proportion of costs to the fixed component to recover costs and ensure price signals are provided to customers to invest and use energy efficiently.

Origin thus encourages the QCA to maintain a consistent approach to the 2015-16 determination in its' allocation of retail costs in 2016-17.

Other Issues

Origin supports the QCA's proposal to include an allowance for headroom on the basis that this is consistent with previous decisions and would:

- assist the transition towards cost reflectivity;
- be consistent with how large business customers are treated in regional Queensland; and
- lessen the subsidy paid by taxpayers.

It is Origin's belief that business customers need to see the cost reflective charges for their electricity consumption in order to make informed investment and usage decisions. Origin, thus supports transitional tariffs being increased to cost reflective levels and appropriate escalation factors being applied by the QCA as applied in previous years.

Closing

Should you have any questions or wish to discuss this information further, please contact Caroline Brumby on (07) 3867 0863.

Yours sincerely

Keith Robertson
Manager, Wholesale and Retail Regulatory Policy
(02) 9503 5674 keith.robertson@originenergy.com.au