



Submission to the  
Queensland Competition Authority  
on the  
Review of Electricity Pricing  
and Tariff Structures

17 July 2009

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## Executive Summary

The Queensland Premier and Treasurer have directed the Queensland Competition Authority (QCA) to review electricity pricing in Queensland. Origin Energy (Origin) welcomes the Ministers' Direction as it provides the avenue and impetus for change to both the current retail tariffs structures and the pricing methodology to be used to reflect future changes to the costs of supplying electricity to Queensland consumers.

Origin believes deregulating retail prices is a priority in accordance with the commitments made by all energy ministers under the Australian Energy Markets Agreement (AEMA).

Origin also appreciates the recognition that all the jurisdictional energy ministers have given through the recent amendments to the AEMA, that where a jurisdiction still retains price regulation at the commencement of the Carbon Pollution Reduction Scheme (CPRS), the jurisdictional pricing regulators will ensure that the costs of this Scheme are passed through in energy prices to consumers. This commitment was essential not only to ensure the future viability of the energy industry (including, but not only, energy retailers) but also to ensure the effectiveness of the CPRS Scheme itself in changing energy use behaviour towards a lower carbon future.

For this reason, Origin has in various fora strongly advocated that where pricing regulation is maintained, jurisdictional regulators work closely together and with the Australian Energy Market Commission (AEMC) to develop alignment in their approach to assessing energy and related costs under a CPRS regime. Not only does this allow a more consistent national response by consumers to the CPRS, but it facilitates each jurisdiction addressing the very real complexities of regulating retail prices in a time of such significant change to the whole energy market.

Origin therefore supports the Queensland government in initiating the current QCA review and we see it as the start of an important journey towards these policy objectives.

Origin also considers that this is a particularly favourable time to initiate a broad review process for Queensland given that in addition to the CPRS, Queensland distribution businesses will be subject to a new network price determination by the Australian Energy Regulator (AER) for the period 2010-11 to 2014-15. This is the first time that Queensland network prices have been set by the AER, and there is likely to be a significant change in network prices and pricing arrangements from 2010-11. As network prices make up some 45 per cent of the total retail price to small consumers, changes in network prices can have a major impact on retail prices.

Unfortunately, these changes in the broader environment also introduce a level of uncertainty and risk that is perhaps unprecedented in the past decade of market reform.

As a result, Origin is strongly urging the QCA to consider the option of a 1 year transition pricing period based largely around existing arrangements, followed by a 3 year price path based on a cost-build up approach. Our reasons are further summarised below and considered in detail in the body of our submission.

### What are the Issues with a 3 Year Regime Commencing 2010-11

Origin notes the Government's preference for a 3 year price determination and agrees that under more normal circumstances a longer price period may be desirable. It provides a mechanism to smooth out the major impacts that are likely to be experienced by consumers as current retail tariffs are reformed to cost reflective levels, while giving both consumers and the industry some certainty.

However, after careful review Origin believes that the current situation makes the introduction of a three year price path covering the period from 2010-11 to 2012-13 an untenable proposition. This is because this particular three year period embraces (as noted above):

- A new AER 5-year determination for Queensland distribution networks commencing 2010-11 and likely to impose major cost changes for retailers and their customers, particularly in the first year;
- The likely (but not certain) introduction of the CPRS in 2011-12 but one based on a \$10 per tonne set price for carbon; and
- The transition to fully tradable arrangements under the CPRS in 2012-13 with a \$40 per tonne cap, international trade in carbon permits, permit auctions etc.

It is Origin's contention that a 3 year pricing regime commencing in 2010 and in the face of the complexities and changes summarised above will be prone to significant errors, putting at risk consumers, retailers and the broader industry. Moreover, it is very unlikely to achieve the pricing certainty that is one of the main objectives of a 3 year price path given the need to include regular reviews.

The situation in facing the QCA is not only exacerbated relative to other pricing regulators by the AER determination for 2010-11, but also, and most importantly, by the time constraints placed on the QCA in conducting this review, with the essential structural elements required to be in place by September 2009.

These time constraints mean that the QCA would be attempting to formulate the approach to and structure of a 3 year price path without any of the essential information required to determine the key elements, including:

- The outcome of the AER review;
- The final policy features of the CPRS;
- The international framework for action on Carbon, post Copenhagen;
- The 20/20 carbon reduction targets (currently ranging from 5% to 25%); and
- The final quantity of free permit allocations under the CPRS.

Facing such policy uncertainty around the CPRS the wholesale market for 2012-13 currently has no liquidity; neither buyers nor sellers are currently willing to take a position on energy costs for this period.

An objective review of the risks of CPRS has been conducted by expert energy consultants Farrier Swier and Origin understands that it is to be provided to the QCA by the Energy Retailers Association of Australia (ERAA). The AEMC and other bodies have similarly highlighted the risks around retail pricing in the initial year(s) of the CPRS.

This submission also highlights the multiple complex issues and risks that are faced when endeavouring to manage wholesale risk in a CPRS world and provides a basis for Origin's serious concerns. The report also highlights the wide discrepancy currently prevailing across the energy modelling experts on the impact of the CPRS on retail prices, a discrepancy that itself is an indication of the lack of information and the policy uncertainties.

As a consequence, Origin strongly supports the 2010-11 electricity prices being set as a single year process with the emphasis being on adjusting prices to the new network regime and starting the journey to pricing reform. A 3 year price determination, based on a cost

build-up approach, might then be applied from 2011-12 onwards<sup>1</sup> when the network issues are resolved and more information is available on the CPRS. We believe that only in this period can an effective cost build-up approach be implemented in Queensland.

#### The Benefits of a 1 Year, 3 Year Approach

In summary, the benefits of this 1 year transition, 3 year price path approach would include:

- relieving the time pressures of constructing and consulting upon a new three year pricing methodology before the end of 2009;
- enabling the completion of the AER's decision on Energex and Ergon's revenue requirements from 2010-11 to 2014-15 before the 3 year price path is determined;
- enabling the pricing framework for the 3 year price path to be set on the basis of considerably more knowledge about the fundamental aspects of both the Australian CPRS and the international carbon market; and
- providing a reasonable time period for the parallel reform of pricing structures with the end-goal of cost reflective pricing, effective competitive market and ultimately, deregulation of those markets.

If this proposal is accepted, then the question that needs immediate attention is what reforms can be started in the transitional year of 2010-11, noting the Minister's objectives regarding:

- supporting implementation of full retail competition;
- headroom remaining relatively stable; and
- customer's reversion to notified prices not causing a financial burden on retailers.

#### 2010-2011 as a Transition Year:

Origin accepts that a 1 year process would preclude moving retail tariffs to full cost reflectivity in south east Queensland in 2010-11. Origin also accepts that the identified time constraints also impact on any changes that can be made to the current benchmark retail cost index (BRCI) methodology.

However, Origin believes that there are several changes that could be made to the way the BRCI methodology operates for 2010-11 that would either:

- make significant steps towards meeting the overall objectives of retail tariff reform; or at the very minimum
- ensure that the cost reflectivity of retail tariffs in south east Queensland does not deteriorate any further in 2010-11.

These changes relate to the manner in which the change in network cost is incorporated into the BRCI methodology. In essence:

1. the network charges used in any adjusted BRCI methodology must be the network charges applicable to south east Queensland customers (ie. Energex and relevant Powerlink charges);

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<sup>1</sup> Assuming that the policy settings for the CPRS are somewhat clearer than they are today.

2. a method that allows the escalation of individual retail tariffs to take account of the variation between how different Energex network tariffs are increasing in 2010-11 is preferred; and
3. the ideal methodology would allow setting of retail tariffs for 2010-11 to take account of variations to the structure and quantum within each Energex network tariff as well.

Origin has proposed several such methods within this submission that could be incorporated within the BRCI so that a process consistent with the last three years could be completed for 2010-11.

### Summary

Origin believes deregulating retail prices is a priority in accordance with the commitments made by all energy ministers under the AEMA.

In the intervening period before deregulation occurs in each state of Australia, jurisdictional regulators, including the QCA, should work closely together and with the AEMC to develop alignment in their approach to assessing energy and related costs under a CPRS regime.

If there is to be price regulation in the next period in Queensland, and taking into account the unprecedented circumstance facing the QCA and the particular circumstance in Queensland at the current time, then Origin strongly urges the QCA to consider the option of a 1 year transitional pricing period for the reason set out above. This does not imply any deviation whatsoever from our position that retail prices should be deregulated.

Origin believe it has put forward a practical alternative that would address many of the current complexities and would, nonetheless, move Queensland towards the objectives set by the Minister for this pricing review.

# 1. Background

On the 26 June 2009, the Queensland Premier and Treasurer directed the Queensland Competition Authority (QCA) to review electricity pricing in Queensland and more specifically, to review:

- whether electricity tariffs in Queensland are costs reflective, providing appropriate price signals and facilitating retail competition;
- the current benchmark retail cost index (BRCI) methodology and whether alternative methodologies would more effectively reflect the changes in costs of supplying electricity to Queensland consumers; and
- alternative pricing and tariff structures to assist in management of peak demand.

Origin Energy (Origin) welcomes the Ministers' Direction given the problems encountered with the current retail tariffs structures and the issues experienced in applying the BRCI methodology. Given the very significant changes that are likely to occur in the Queensland energy market over the next few years, it is also most opportune of the Minister to initiate a broad review process.

As part of Stage 1 of the consultation, the QCA released its *Request for Comments Paper: Review of Electricity Pricing and Tariff Structures* (QCA Paper) on the 26 June 2009 inviting stakeholders to comment on the appropriateness of the BRCI process, the state of current retail tariffs and to propose alternative pricing methodologies.

This Origin submission responds to the specific issues and questions raised in this document. It highlights the major issues experienced with the current framework and proposes several changes and alternatives that would go some way towards meeting the objectives of the Direction.

However, Origin believes that:

1. it is unrealistic for all the necessary changes to electricity prices and the formulation of a new price setting framework to be completed prior to the setting of electricity prices for 2010-11; but also
2. that attempting to set a methodology to determine a 3 year price path for retail tariffs at this point in time is unworkable due to the uncertain impact of significant factors such as the Carbon Pollution Reduction Scheme (CPRS) and the Australian Energy Regulator's (AER) determination of new network prices for Queensland networks.

Nevertheless, Origin is cognisant of the potential benefit to consumers and retailers alike of providing more certainty and stability in electricity pricing. Origin therefore propose an approach that both acknowledges the difficulties of setting a long-term pricing approach prior to the 2010-11 pricing year and also sets a direction that may facilitate such an approach being established to apply for future years.

These issues are discussed below.

## 1.1 Timing

One of the central lessons of the past three years is the importance of conducting an open, transparent and consultative process in which all affected parties can have confidence not only in the framework, but in the assumptions and data that feed into the outcomes of the process. This is essential when the QCA is being required to make recommendations and

decisions of great substance, and ones that cover a period of significant industry change, uncertainty and lack of information.

It is Origin's view therefore, that timing is a critical element of the current review and must be considered fully even if it imposes constraints on the selection of a proposed approach.

Origin notes that the Direction requires the two stages of the process to be completed by 31 August 2009 and 30 November 2009 respectively and is therefore cognisant of the limited time available for this consultation.

Clearly, the Queensland Government would also be required to amend legislation in order to enact any substantive changes to the current methodology as a consequence of this review. This will also expend time.

Any new methodology would also necessarily include consultation with market participants but with the constraint that retail tariffs must be in place for 1 July 2010.

Furthermore, sections 2 and 3 of this submission contain Origin's assessment of the state of the current electricity retail tariffs and the performance of the BRCI methodology. It exposes that there are significant issues with both elements so that full remediation of the issues will be extensive.

Given these pressures, Origin is concerned that although the objectives of the review deserve support, if a complete overhaul of the current methodology was undertaken in the proposed timeframe then the benefits of the review may be lost in a poorly implemented approach.

Origin believes that if all objectives of the review were attempted in the proposed short timeframe then there is a significant risk of:

- insufficient analysis and use of inadequate data;
- the future methodology not being fully consulted upon nor transparent;
- the objectives of the review not being met effectively; and
- significant and ill-considered impacts on Queensland customers.

## **1.2 Australian Energy Regulator Determination**

As highlighted throughout this submission, one of, if not the major issue with the current Queensland retail tariffs is their misalignment with network charges both as they stand and as they change year to year. Network charges make up some 45% of the total retail charge to customers.

Origin would also highlight that while the structure of retail prices have not been changed, network tariffs have evolved through the process of network and transmission regulatory re-sets under the auspices of the QCA and, in the future, the AER.

Origin notes that the many of the questions raised in the QCA Paper refer to this issue and how it can be resolved. Origin is appreciative that this important issue is being addressed. In section 4 of this submission, Origin answers these questions directly and proposes various ways that Energex's network tariffs can be incorporated within the retail tariff structure so that at the very least, south east Queensland customers will be receiving cost reflective charges.

However, as the QCA would be aware, the Queensland distributors (Energex and Ergon) have only recently submitted their proposals to the Australian Energy Regulator (AER) for their future revenue requirements from 2010-11 to 2014-15.

Although Energex's Annual Average Revenue Requirements (AARR) and average increase in network charges for 2010-11 will be known by early in 2010 for use in the retail price setting process, actual network tariffs and structures may not become clear until June 2010.

This raises serious concerns as to whether the network charges and structures themselves can be used directly in setting retail tariffs for 2010-11 and in any 3 year price path. These concerns are emphasised by it being a new network determination and that it may include significant new or significantly changed network tariffs.

### 1.3 Carbon Pollution Reduction Scheme

The CPRS is scheme that has been developed by the Federal Government as a mechanism to drive down the carbon intensity of the Australian economy and consumers using a cap and trade scheme to achieve the lowest cost abatement. It is one of a number of policy instruments that have a particular impact on the energy industry and energy users. Other policy instruments that relate to the energy industry include a much expanded Renewable Energy Trading Scheme (eRET) and multiple national and state energy efficiency schemes.

While the Federal Government remains committed to a cap and trade mechanism as central to the CPRS, the legislation to implement this approach still sits in legislative limbo. Significant changes have already been made in the last few months in an attempt to gain political support in the Senate. The CPRS, as it is currently proposed, features:

- a commencement date of July 2011;
- a transitional year for 2011-12 with a fixed carbon price for Australian Energy Units (AEUs) of \$10 per tonne;
- From July 2012, AEU prices will be determined by the market subject to a price cap of \$40 per tonne; and
- A 2020 target ranging from a 5% to 25% reduction in CO<sub>2</sub> depending on international developments.

In summary, the next three years will see a series of fundamental changes and adjustments, yet this is the same three years where it is contemplated imposing a single wholesale energy cost methodology (determined in 2009) as part of a 3 year price path.

Moreover, this is only one aspect creating substantial uncertainty about the long term price path and associated wholesale electricity cost model. A list of uncertainties and inter-correlated risks includes:

- Policy and Regulatory Uncertainty: Given the stance of the Federal Opposition parties to date, the industry can have no confidence that the CPRS will retain the current features;
- International Developments: The current CPRS trajectory is linked directly to international commitments and there are no guidelines to make this judgement at this time, yet this trajectory will have a significant impact on future energy costs;
- Carbon Price Uncertainty: There is minimal information available on the future price of carbon, which will be affected by multiple factors (many themselves unknown at this time) such as the number of free permits issued, the value and number of eligible

international carbon permits and the impact of other energy efficiency and renewable energy commitments;

- The costs, mix and merit order of old and new generation: This includes the strategies of generators as reflected in their contract and bidding behaviour, the impacts on debt covenants, counter-party credit risks and the impact of the CPRS and eRETS on the price of gas and coal for peak and intermediate generation;
- The development and nature of any carbon hedging markets: While a carbon hedging market is likely to emerge under a cap and trade scheme, there will initially be some delays before this has sufficient liquidity to enable retailers to manage the risk of their mass market load; and
- The impact on associated costs such as transmission and distribution costs: The CPRS and, more particularly, the eRET is expected to drive substantial changes in transmission (electricity and gas) arrangements that will have flow on effects to retailers both directly and indirectly through the wholesale costs of electricity.

Given these many uncertainties, it is not surprising that there is a wide range of opinions amongst the energy consultancy industry regarding the impact of the CPRS and eRET on retail costs, a spread that should act as a further “warning signal” to pricing regulators.

A number of these were summarised in a report by Frontier Economics (Frontier) to the AEMC.<sup>2</sup> This report:

- identified a range of forecasts by different consultants of the carbon cost-pass through rate<sup>3</sup> by generators, ranging from around 40% to over 115%;
- assessed three (viable) scenarios for CPRS pass through rates by generators (60%; 80% and 100%). Frontier estimated an impact on total retailer costs of between 10 to 30% depending on the scenario adopted; and
- found that the range of possible impacts on total retailer costs (between 10 to 30%) far outweighs the retail margins of 5% typically allowed by pricing regulators.

The outcomes described above relate to variation in only one of the possible factors (CPRS pass through rate) that need to be considered in setting regulated retail prices. Also to be considered is the price of carbon and the other factors listed above which will impose risks that are in turn exacerbated by the short time available for appropriate consideration of these complex issues.

## 1.4 Origin’s Proposal

Given the issues highlighted in sections 1.1 to 1.3, namely:

- the time constraints upon this review;
- a new AER determination for Queensland distribution networks by June 2010; and
- the likely introduction of CPRS in 2011-12 with transition to fully tradable arrangements by 2011-12 ;

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<sup>2</sup> Frontier Economics report prepared for the AEMC, May 2009. Quoted from Farrier Swier Consulting; *Managing CPRS transition: implications for electricity retail price regulation*.

<sup>3</sup> The carbon cost pass through rate is simplistically, the proportion of the prevailing market carbon price that is reflected in generators contracting and bidding behaviour. Some commentators consider that given the drivers (such as debt obligations) on generators to be dispatched into the market, carbon costs will not be passed through in full. However, other commentators point to the fact that the NEM market is settled on the marginal generator bid and that there may be an incentive to bid prices that exceed the carbon cost.

Origin cannot support the Government's preference for a three year price path commencing in 2010-11.

Origin has often supported the certainty provided by 3 year price paths but the uncertainties introduced by the progressive roll-out of significant changes first in the network price regime, and then the advent of CPRS over the next three years make the introduction of a 3 year price path from 2010-11 untenable. These risks cannot simply be ameliorated by the inclusion of re-openers during the price-path<sup>4</sup>.

The reasons are made clear in this submission.

As such, Origin strongly advocates that the QCA and Queensland Government consider setting the 2010-11 electricity prices as a single year process and establishing a 3 price setting methodology from 2011-12 onwards when more information is available on the CPRS. This would also relieve the time pressures of trying to construct and consult upon a new 3 year pricing framework before the end of 2009.

Limiting the price determination period to one year does suggest that moving retail tariffs to full cost reflectivity in south east Queensland in 2010-11 would be difficult. However, there are several transitional changes, both minor and major, that could be made to both the BRCI methodology and the retail tariffs for 2010-11 that would make significant steps towards meeting the overall objectives of tariff reform. At this point in time, Origin proposes that the QCA incorporate some of these changes into the BRCI and a process consistent with recent years be completed for 2010-11.

This would provide the necessary time for consideration of a methodology that can be used for the 3 year price path and to ensure that retail prices can move to full cost reflectivity without unexpected or inefficient impacts.

Consequently, in section 4 of this submission Origin has attempted to identify the major changes that can be readily accomplished in this short period to best meet the objectives of the review. It has not attempted to select or detail an appropriate methodology for use in any future 3 year price path.

Origin has also attempted to highlight some of the further issues that would need comprehensive data, analysis and consultation in order to fully address any concerns prior to implementation.

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<sup>4</sup> Origin considers that the likelihood for a re-opening is such that the very rationale for a 3 year period (stability and predictability) would be undermined.

## 2. Effectiveness of the current BRCI methodology in achieving cost reflectivity

The BRCI methodology was first established with the intention that the electricity retail tariffs that applied at the time (in 2006-07) be escalated annually to reflect the annual changes in the cost of supplying electricity to Queensland customers.

There was no attempt to make the retail tariffs of the day cost reflective. The objectives of the legislation clearly show that the operation of the BRCI was simply to maintain the positive or negative margins in the retail tariffs that existed at that time.

Origin would note that if the BRCI had operated as initially intended then it may have achieved this purpose. It was not, however, successful.

- Does the current BRCI framework produce regulated retail electricity prices that are reflective of the costs of supplying electricity in south east Queensland?

The BRCI attempts to escalate the electricity retail tariffs by a fixed percentage each year to replicate the annual change in the cost of supplying electricity to Queensland customers. This percentage is uniformly applied across all electricity tariffs.

The starting point of the methodology was the 2006-07 retail tariffs and these were not cost reflective at the time. Therefore, given the nature of the BRCI to only estimate change in cost, that deficiency has not been rectified in the last three years. Retail tariffs remain not reflective of cost with some retail tariffs not meeting the cost of supply with others exceeding the cost of supply.

With regard to the BRCI framework itself, Origin has criticised the BRCI in the past based on the interpretation of how costs should be calculated, inconsistencies in the index over time, and errors in calculation rather than the index itself. As a method for estimating change in cost, Origin believes the current BRCI framework has the potential to adequately measure the change in the wholesale energy and retail cost from one notified price period to the next, providing the general energy market environment remains relatively stable. For instance, in the past, the BRCI was not responsive to the significant volatility and rapid changes in energy costs during the recent drought. Its effectiveness as a means to capture retail costs as we approach the CPRS is even more problematic.

Moreover, the treatment of network costs within the BRCI has meant that the BRCI was limited in achieving its purpose.

As a result, the uniform electricity tariffs, as they apply to south east Queensland, have actually become less reflective of actual cost over time. This is because of three factors:

1. the calculation of the BRCI and its subsequent use in escalating electricity tariffs is based on the change in total network costs in Queensland - that is, an average of Energex, Ergon and Powerlink costs<sup>5</sup>. This has meant that any large increases in Energex's network cost for south east Queensland customers have only been partially reflected in the retail tariffs because of this averaging process.

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<sup>5</sup> The distortion created by this 'averaging' was exacerbated by the amendments to the original BRCI treatment of network charges as set out in the Ministerial Delegation of March 2008. This change embedded into the formula an anomalous relationship between changes in Ergon prices (which had gone up 30% prior to the BRCI, but were flat after that) with Energex prices which increased on a straight line basis.

This has resulted in network costs increasing at a greater rate than is being reflected in retail prices;

2. the BRCI escalation is applied to all retail tariffs consistently despite the costs underlying each specific tariff changing at different rates. This is clearly observable with regard to the network tariffs in south east Queensland.

The BRCI takes into account the average cost for network increases but Energex's individual network tariffs vary markedly between customer classes. For example, the BRCI may allow for a 5 per cent average increase in network costs and retail tariffs may be escalated accordingly. However, the actual network increases that are underlying two different tariffs may be 0 per cent and 10 per cent in actuality so both tariffs become less reflective of underlying cost with one cross subsidising the other; and

3. the BRCI escalation is applied to a single retail tariff consistently across all its price elements such as its supply charge and variable charge. However, the network price elements underlying the retail tariff can and do change at different rates. The Queensland distribution networks have the ability to change and rebalance network elements and do so regularly.

Therefore, even if a 5 per cent average increase in network cost is reflected accordingly in the retail tariffs, the actual network increase may focus all the increase in the fixed supply charge. As a result, the retail tariffs become less reflective of underlying cost across the entire customers base accessing the tariff and cross subsidies are introduced.

These network issues within the BRCI have had a significant impact on cost reflectivity because network tariffs make up almost half the total cost for supplying electricity to Queensland customers.

The consequence of this deterioration in cost reflectivity is that even if the BRCI produces overall cost reflectivity for south east Queensland, competition will ensure that those customers with higher margins are competed away. As this occurs, it is Queensland customers on retail charges that don't meet the cost of supply that will remain on regulated tariffs and provide a commercial burden.

- **If not, would the BRCI methodology as it is currently applied be appropriate if existing retail tariffs were reviewed for cost-reflectivity and the BRCI then applied to the revised tariffs?**

Origin is a participant in the Queensland energy market but more specifically, the area retailer for south east Queensland with an obligation to provide supply to any prospective new customers on regulated retail tariffs.

Consequently, Origin's ultimate aspiration for this review is that all retail tariffs in south east Queensland are rebalanced and realigned to become cost-reflective. It is only if this condition is met, that the Minister's stated objective that "*customers who revert to notified prices should not result in a retail entity providing customer retail services to small non-market customers at a loss*" can then be assured.

However, it is clear that even if retail tariffs were rebalanced to be cost reflective immediately, the BRCI in its current form is not the appropriate method to sustain retail tariffs at that position.

The major reasons are discussed in more detail above but in essence, the current BRCI cannot effectively track annual cost changes because:

- the calculation of the current BRCI is based on the change in total network costs in Queensland rather than specific south east Queensland network costs;
- the BRCI escalation is applied to all retail tariffs consistently despite the costs underlying each tariff changing differently; and
- the BRCI escalation is applied to a single retail tariff consistently across its price elements but the network price elements underlying the retail tariff can vary significantly.

Origin would also highlight that the BRCI is calculated on the total NEM load profile for Queensland and not the profile relevant to customers subject to notified prices generally, or more particularly for south east Queensland. This also undermines the relevance of the BRCI to actual cost changes.

Origin recognises that adjustments can be made to the manner in which network charges are handled within the current BRCI framework and that these could improve the appropriateness of using it to sustain retail tariffs at cost reflectivity. Origin highlights some of these potential adjustments in section 4 of this submission.

### 3. Assessment of existing tariffs

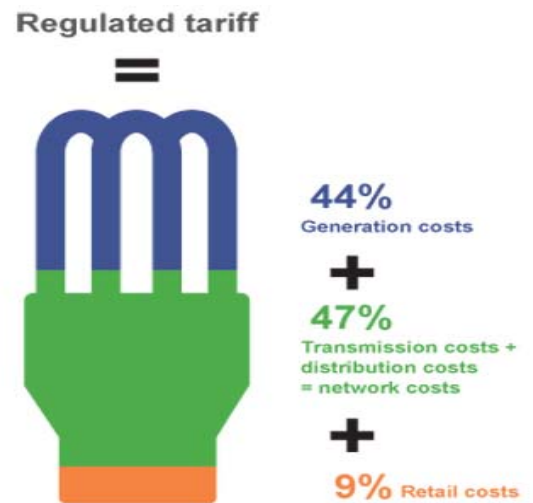
#### 3.1 Current Tariffs and Tariff Structures

As highlighted in section 2, current retail tariffs structures remain as they were in 2006-07 and have only been uniformly escalated despite substantial changes to the network tariffs that underpin the different tariffs. Consequently, Origin has substantive concerns about various retail tariffs including their:

- cost reflectivity;
- relevance; and
- even usefulness.

When examining the cost reflectivity of current retail tariffs in Queensland, it is important to understand that electricity prices are made up of four separate costs:

- generation costs which are the cost of creating electricity at a power station;
- transmission costs which are the costs of building and maintaining Queensland's extensive high voltage powerline infrastructure ;
- distribution costs which are the costs of building and maintaining Queensland's network of poles and wires that deliver electricity to homes and businesses; and
- retail costs which are the costs of connecting, billing and managing the accounts of customers. <sup>6</sup>



The cost reflectivity of current retail tariffs in south east Queensland can then be simply examined by adding together the separate network costs, generation or energy cost and retail cost of a customer and comparing this against the actual retail charge the customer pays. When the retail charge exceeds or is less than the actual cost of supply as calculated then the tariff is not cost reflective.

Origin has examined the cost reflectivity of the 2009-10 retail tariffs by comparing them against the 2009-10 Energex and Powerlink distribution and transmission network costs and by using the energy and retail costs identified by the QCA in their recent 2009-10 BRCI decision as benchmarks<sup>7</sup>.

It should be highlighted that any analysis of cost-reflectivity on current retail tariffs may well be markedly different once the new network tariffs, set under the AER determination and making up 47% of the total regulated tariff in the chart above, come into play.

<sup>6</sup> Source: [http://www.dme.qld.gov.au/Energy/electricity\\_costs\\_affect\\_prices.cfm](http://www.dme.qld.gov.au/Energy/electricity_costs_affect_prices.cfm)

<sup>7</sup> While Origin does not agree with these energy costs calculated in the BRCI, they are used here to simplify the analysis of cost-reflectivity within and between the current retail tariffs.

- |   |
|---|
| <ul style="list-style-type: none"><li>• Are any of the current tariffs insufficient to recover the efficient cost of supplying electricity in south-east Queensland??</li></ul> |
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This basic analysis highlights the challenges of retail pricing reform generally and in particular:

- that there exist retail tariffs that are insufficient to recover the cost of supply for all customers using that tariff;
- that the cost reflectivity of several retail tariffs is dependent on the customer's physical connection and metering and hence their applicable network tariff; and
- even within many of the retail tariffs that are broadly cost reflective, there is little to no alignment between retail and network charges which results in retail charges that do not recover the costs of supply for many customers in specific consumption bands. That is, cross subsidies exist within the retail tariff.

Tariffs that demonstrate examples of the above instances are provided to the QCA as a confidential attachment to this submission. However, the principal issues are discussed below.

### *3.1.1 Tariff insufficient to recover Costs*

Retail tariffs that clearly do not recover their cost of supply are the tariffs that apply to Large commercial and industrial customers (Queensland customers consuming >100 MWh per annum). However, even the controlled load tariffs (tariffs 31 and 33) are predominantly insufficient to recover costs as are the irrigation and farm tariffs (tariffs 62, 65 ad 66).

Many commercial and industrial customers in Queensland, both Large and Small, remain on regulated retail tariffs.

Unlike other jurisdictions, the current Queensland policy allows for existing Large customers to remain on regulated tariffs (if they have not taken up a market contract in the interim) and for any new Large customer to be able to access regulated tariffs. This in turn creates incentives for Large customers to remain on the regulated prices that are designed for Small customers and do not reflect the demand pricing signals that are so important for promoting efficient energy use in this segment.

### *3.1.2 Consumption classes within tariff insufficient to recover Costs*

Many other retail tariffs are only cost reflective if a retailer holds a range of customer consumption types because of the cross subsidies inherent within the tariff itself. For example, many customers with specific consumption patterns are not priced to recover their costs within the tariff.

Such situations may arise where:

- there is an imbalance between fixed and variable costs and fixed and variable revenue; and
- the underlying network tariffs have a different structure than the corresponding retail tariffs.

Origin's preliminary analysis indicates that there are a number of tariffs where these issues may apply. These include the main residential tariffs and also Large customers on regulated

tariffs with demand based network tariffs. With significant changes in network prices possibly arising in 2010-11 (from the AER review), such anomalies may well increase.

### 3.1.3 *Tariffs in excess of Costs*

Origin's analysis did reveal at least one tariff that appears to be above the costs for all customer types and sizes in south east Queensland, at least based on the BRCI energy costs that were used for the purpose of this analysis. Such customers may well benefit from the process of tariff reform.

- **Do, the current tariff structures send appropriate price signals to customers to enable them to manage their use of electricity and, if not, why not??**

The current tariff structures clearly do not send the appropriate price signals to consumers given that there is no pass-through of network pricing and often a complete misalignment between electricity supply costs and regulated retail tariffs. As noted, this lack incorporates both the:

- price signals regarding efficient use of network assets not being reflected in the various retail prices; and
- the fixed and variable costs pertaining to various tariffs also not being transparent.

In addition, any additional pricing signals that the network wishes to communicate to consumers such as energy loss mitigation through use of kVa tariffs or minimising use of the network at peak period through demand pricing are currently unachievable.

Under the current situation, if the network introduces an additional pricing signal to its charges it will simply encourage customers that will benefit from the new pricing methodology to enter into a market contract but any customers that will be penalised by the new pricing will simply remain on current retail tariffs with no additional impact as the retailer will be subsidising their network bill.

From a retail point of view, the current retail tariff structure with a flat variable rate does not allow price signalling to take account of the time-related variations in the wholesale energy cost. This may include:

- time of use during the day;
- time of use during the week; and
- the variation in energy cost between seasons such as winter or summer.

- **Do the current tariff structures facilitate effective retail competition and, if not, why not??**

The current tariffs structures and level of retail tariffs does not facilitate competition.

As Origin has already highlighted, many retail tariffs are not cost-reflective which inhibits competition in south east Queensland. This is never more apparent than for new Large industrial customers that continue to access regulated tariffs rather than enter the competitive market.

Furthermore, many other retail tariffs are generally cost-reflective but contain inherent cross-subsidies. Therefore, rather than all customers having access to a competitive offer,

the current structure of retail prices only provides for a proportion of customers to be able to benefit through the competitive energy market.

### 3.2 Obsolete Tariffs

- Are there any tariff categories which no longer serve a customer need that cannot be accommodated in another tariff? If so, is it reasonable for those tariff categories to be retired?
- Could any current tariff category be consolidated into another tariff category? Would such consolidation unfairly discriminate against any particular customer class?
- Are there any tariff categories that provide perverse price signals?

The QCA has listed 20 retail tariffs within its Paper including three tariffs that are currently obsolete.

The primary goal for retail tariff reform is alignment or pass-through of network charges appropriately. Based on the current Energex network tariffs, opportunities clearly exist for consolidation or removal of retail tariffs.

To explain, a customer on a certain network tariff can currently be accessing several different retail tariffs despite the retail and energy cost often not varying between these tariffs. For example, a customer on Energex's Business Medium network tariff could be on retail tariff 20 or retail tariff 21. Unless there are significant differences in the customer's wholesale energy cost because of time of use or seasonality, there is only a need for a single retail tariff to reflect a certain network tariff.

Origin would highlight to this point, consolidation of retail tariffs has only gone as far as making certain tariffs obsolete and not accessible by new customers. Unfortunately, customers already on these tariffs remain and given that they usually are below cost-reflectivity, there is no incentive for customers to move from them. Any reform of retail tariffs as a result of this review cannot allow such behaviour if it is to have any practical purpose.

If and when tariff reform enables network charges to be directly passed through or indirectly incorporated into bundled retail tariffs then current retail tariffs should become redundant and new retail tariffs would be based on retail controllable cost added to each network tariff.

## 4. Assessment of alternative pricing methodologies for setting regulated retail tariffs

A review of the QCA's July 2009 Information Paper, shows some of the important pricing principles in determining regulated tariffs in other states. They are:

- the flexibility to rebalance individual tariffs - for example, in New South Wales a Standard retailer has the freedom to rebalance individual tariffs within a weighted average price cap decision. In South Australia, the Standing Contract retailer has the flexibility to rebalance their controllable costs (energy and retail cost) to which the network tariffs are then simply added;
- a consistent and robust pricing methodology over time;
- the right to review tariffs - any three year price path without triggers to initiate review places unacceptable risks on retailers. This is a critical issue given the current uncertainty of the CPRS; and
- a move towards Price deregulation - price regulation should be moving to less prescriptive methods to allow for effective competition and eventually price deregulation such as in Victoria;

In this section, Origin has responded to the questions raised by the QCA on alternative pricing methodologies but keeping in mind the following factors:

- the current BRCI methodology;
- the pricing principles outlined above;
- the timing constraints of this review process;
- the impact of alternate pricing on customers;
- the short-term goal of retail tariffs reflecting underlying costs including south east Queensland network tariffs; and
- the end goal of retail price deregulation.

Origin has also assumed that setting the 2010-11 electricity prices is a single year or transitional process. Origin does not consider the option of an acceptable three year price path applying from 2010-11 to 2012-13 as remotely possible and therefore has not commented on potential frameworks that could be used in this manner.

Origin believes that the three year price determination should be set from 2011-12 onwards when more information is available on both the CPRS and the industry's response to the CPRS and to also allow further consideration of tariff reform.

However, significant steps towards meeting the objectives of tariff reform can be made in 2010-11 with minor adjustments to the current BRCI process depending on the Government's appetite for significant customer impacts. Origin therefore proposes several adjustments that enhance the current framework with varying degrees of difficulty and impacts on consumers.

## 4.1 Cost of Energy

- What is the most appropriate method to estimate the costs of energy for the future tariff years under review?

Origin strongly recommends that a BRCI methodology be maintained for the 2010-11 price determination, or at least the retail and energy component, albeit with some modifications that are discussed in this submission.

Origin does not believe the BRCI methodology calculates an accurate wholesale energy cost figure, however, as the focus of the BRCI is on the annual change in energy costs, the absolute value of the energy cost in the BRCI is relatively less important. In marked contrast, a change to a cost build-up approach, in which the absolute value of the energy costs are critical, will require extensive consultation with the industry and considerably more time and policy/market information that the QCA has available to it over the next few months.

Therefore, Origin suggest that the current general method of calculating the energy cost component of the BRCI is used for 2010-11 as it fairly transparent in method of calculation and produces results which are verifiable, relative to the market data for that year<sup>8</sup>.

Origin would note that the current uncertainty about the CPRS legislation and its impact on the various components of the energy value chain makes it difficult to specify an appropriate modelling framework that captures the risks appropriately (for 3 years ahead). The market with all its experience and expertise doesn't yet know how to price future energy contracts; nor do the energy consultants and other industry experts who have all taken very different positions on the outcome for contract and spot prices, on the generation mix and input costs and on almost all other aspects of the total energy market.

The earliest time that the CPRS will have more clarity, and therefore the market more liquidity, is late in 2009, or the first quarter of 2010. This is too late for the 2010-11 determination. Any decisions made before that are guess work, noting here that major Australian consultants have forecast a large range of potential outcomes of the impact of CPRS on retail prices<sup>9</sup>.

- If the LRMC is included, how should it be estimated?

Origin is not generally supportive of the use of LRMC in energy cost calculations although the LRMC can provide a useful indication of the "floor" for market prices providing it is appropriately specified. However, the LRMC does not, and cannot, reflect on its own the prices retailers actually pay at any period of time and the risks that retailers must manage in terms of price and load volatility.

However, in the current BRCI calculation, the current 50/50 weighting of LRMC and energy purchase cost has provided stability to the index by moderating the price volatility of the forward curve with more long term stable view of the cost of generating energy.

Therefore, although Origin has issues with the current level of capital cost and fuel costs and the general use of NEM Load for calculating franchise tariffs, Origin is supportive of retention of the current BRCI energy cost framework including the LRMC and its greenfields

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<sup>8</sup> Since the CPRS was postponed, the 2010-11 forward contract market liquidity has greatly improved.

<sup>9</sup> Farrier Swier 2009, *Managing CPRS transition: implications for electricity retail price regulation*

approach for one more year. Origin believe this is a practical solution given the current QCA time-frame and the delay in finalising the CPRS and its implementation.

Beyond 2010-11, however, the introduction of CPRS will obviously impact on an LRMC calculation. In addition, the industry is only just starting to come to terms with the impact of the new renewable energy targets (20/20) not only on the cost of RECs but also on the generation mix, transmission requirements and augmentations. Constructing an LRMC methodology in 2009, to cover the 3 year period is not at this stage either feasible or desirable.

Origin must acknowledge that the QCA was appropriate to exclude carbon from the 2009-10 LRMC calculation and suggests a similar exclusion from the 2010-11 LRMC. One of the major drivers in Origin pursuing a single year rather than 3 year price path is the uncertainties with CPRS so customers should not be impacted in 2010-11.

- **If the cost of purchasing energy in the market is included, how should it be estimated?**

For 2010-11, Origin is supportive of the current methodology to calculate the cost of purchasing energy in the BRCI, which is market based and uses published futures prices. As noted, adequate market data is available for 2010-11 to construct a forward price based on the current methodology.

It is imperative, however, for the purposes of retaining the integrity of the BRCI for 2010-11 that the current methodology which averages 24 month purchase price of flat swaps, peak swaps, and caps for the tariff year, continues to be the method of calculating the energy purchase cost. A prudent retailer cautiously buys over the two year time period in order to hedge the year in question. The forward Queensland electricity market has been volatile and any shortening of the window will not be reflective of the energy purchase costs faced by retailers over time.

Origin does assert, however, that such a model, while reasonable for 2010-11, cannot at this point in time be constructed beyond 2010-11. The very lack of liquidity in the wholesale market for the years beyond that demonstrate that the market as a whole has little confidence in modelling and in buying and selling beyond that period.

- **If a mix of LRMC and purchase cost is to be adopted, as is the case at present, how should estimates of these two components be combined?**

Origin believes the current mix of 50 per cent LRMC and 50 per cent purchase cost is acceptable and should be retained, but only if the BRCI is utilised for 2010-11. This provides for a steady price path as the LRMC is likely to be stable and counteracts the volatility of purchase costs.

To be clear, however, Origin would not accept the approach as appropriate in the context of a 3 year price path commencing in 2010-11.

- **How should the potential cost changes associated with environmental obligations such as the CPRS and the expanded RET be included?**

Until the CPRS legislation is enacted, speculation about how it may affect the forward curve for electricity is unhelpful and certainly not a method to set notified prices. This is a fundamental reason why Origin wishes the 2010-11 retail prices to be set separately before

a 3 year price determination is proposed with the potential significant and currently unknown impacts of CPRS.

For 2010-11, Origin suggests that the eRET costs be incorporated as per the current BRCI methodology. However, beyond 2010-11, the situation becomes considerably more complex. For instance, the interactions between the CPRS and eRET obligations are also little understood as are the impacts of eRET on other input costs such as transmission.

For 2011-12 and beyond, consideration can be given to the issues raised by the AEMC (and others) including their most recent report in June this year<sup>10</sup>. The AEMC report highlighted the essential requirement for “flexibility”, reflecting a number of general principles such as:

- the mechanism for regulating tariffs should be flexible enough to incorporate changes to allow for carbon price and therefore the electricity price forward curve volatility;
- the impact of carbon costs may need to be reviewed more frequently than the tariff determination eg. every 6 months; and
- there should be a trigger mechanism to initiate a review due to unexpected carbon impacts on the forward price curve. This trigger could be symmetrical for higher or lower than expected costs.

In addition to the AEMC’s comments, which Origin supports, Origin has also highlighted the need for a sound and consistent underlying methodology that will adequately reflect the costs and risks of the CPRS. Origin has urged jurisdictional regulators to work with the AEMC to develop a consistent framework to reflect a national program of such importance as the CPRS.

## 4.2 Network Costs

Although Origin is proposing that a single year price determination be completed for 2010-11 as a transition year and that the BRCI is acceptable for one more year with regard to energy and retail costs, Origin is not suggesting that the BRCI be used as it currently stands.

As identified in Origin’s analysis of the current retail tariffs and the performance of the BRCI, the current method for incorporating network costs within the BRCI is the single most important reason for the deterioration of the cost-reflectivity of individual retail tariffs as well as the failure of the BRCI to fulfil its objectives.

Origin therefore suggests that the necessary adjustments be made to the BRCI to ensure that the network costs are appropriately incorporated. The manner which network costs or tariffs are treated for 2010-11 will depend on the pace of transition sought by the Queensland Government.

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| <ul style="list-style-type: none"><li>• <b>Should network costs be removed from retail tariffs and treated as direct cost pass-through to customers?</b></li></ul> |
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Ideally, network cost should be removed from retail tariffs and treated as a direct pass-through to customers. Network costs are not controllable by the retailer and hence should not impact on a retailer’s costs or return and should simply be added to the retailer’s energy and operating costs and retail margin.

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<sup>10</sup> AEMC: *Review of Energy Market Frameworks in light of Climate Change Policies, 2<sup>nd</sup> Interim Report*, 30 June 2009. pp49 - 59.

However, pass-through of network costs does not need to be directly to the customer and can be incorporated into a bundled tariff as is done in South Australia. This ensures customers receive an accurate pass through of network cost but is more manageable from a practicality, systems and customer management point of view.

Although direct or indirect network cost pass-through is the ideal situation, the impact on Queensland customers will be highly significant if it is completed as part of a single year process because of the current state of the retail tariffs. Furthermore, the impact would be compounded in 2010-11 by any significant changes to network tariffs resulting from the AER Determination of Queensland distribution networks to be made in June 2010.

It must be understood that network tariffs are dynamic so that the required adjustments to retail tariffs to achieve cost reflectivity is also changing and must not be allowed to deteriorate.

Furthermore, Origin's analysis of current retail tariffs profitability suggests that the impact of a network tariff pass-through may mitigate or smooth the impact of CPRS on many customer classes within tariff.

Origin therefore believe it would be more appropriate if the movement to full pass-through of networks costs is completed as part of the subsequent 3 year price determination; although this process can commence in 2010-11.

This is sensible when it is considered that in order to pass-through network costs within regulated tariffs, there must also be a calculation of the retailer's total costs including the wholesale energy cost. Origin does not believe the BRCI calculations are appropriate for use in a cost build up approach as it has submitted many times previously. Origin also cannot envisage the development, consultation and implementation of a methodology before June 2010 that will provide a satisfactory basis for a cost build-up for south east Queensland tariffs.

Even though the tariffs may not be able to reflect their underlying network charges immediately, Origin has proposed three methodologies that include the appropriate Energex network tariffs within a 2010-11 retail price determination but progress cost-reflectivity to different levels.

1. As a bare minimum, Origin proposes that the network cost used to derive the BRCI escalation for 2010-11 is based on the 2010-11 network charges for south east Queensland, namely Energex's DUOS AARR and the relevant proportion of Powerlink TUOS AARR.

This method can be completed quite simply and becomes a mathematically exercise to ensure the south east Queensland DUOS and TUOS are prorated for both years of the BRCI calculation to a level that provides for the same proportion of the 2009-10 index as the total DUOS and TUOS was found to makeup.

This method would ensure that cost-reflectivity in south east Queensland is not impacted by the use of average network charges rather than south east Queensland network charges for a 2010-11 BRCI.

This method however, does not account for any further impact on retail tariff cost reflectivity due to Energex rebalancing of its network tariffs nor restructuring of individual components of its network tariffs. This remains a substantive and ongoing risk.

2. An extension of the use of south east Queensland network tariffs in the BRCI is for separate escalation factors for each tariff to be derived through the BRCI process for 2010-11. This method would utilise the south east Queensland network charges but then provide flexibility for retail tariffs to be escalated at different rates according to their cost changes.

The separate escalation factors for each retail tariff could be calculated based on the increases in the individual network tariffs for 2010-11 or alternatively, could be subjectively determined by an incumbent retailer as with the New South Wales regulatory framework.

This method also removes the issue of averaged network charges being used for south east Queensland but also mitigates the impact of any rebalancing of network tariffs by Energex. It however, does not account for any structural change in network tariffs.

3. A final method builds on the above proposals but ameliorates the impact of any further structural change to network tariffs.

It requires the current network tariff components to be explicitly removed from the current retail tariff components to arrive at a residual fixed charge and variable components that effectively account for the current energy and retail costs contained within the retail tariffs. These residual elements can then be escalated by a BRCI which is calculated to only reflect the change in energy and retail costs. The resulting elements can then be added to the new network tariffs for 2010-11 to arrive at new retail tariffs for 2010-11.

As the actual network tariff changes are directly built into the retail tariffs, it is clear that the cost reflectivity of retail tariffs will not be impacted when compared to 2009-10.

One issue arising from such a method is that in some tariffs, for example tariff 11, the fixed charge for the network tariff is greater than the fixed charge for the retail tariff. The remaining element would therefore be negative and should obviously not be escalated using the BRCI. This does provide an opportunity to improve cost reflectivity of retail tariffs if any negative elements such as this one were limited to zero.

There are many other variations to these proposals which could be adopted but each will have a differing impact on cost reflectivity and hence, customers total charges. It will therefore be a question of how far changes to the retail tariffs should be taken for the 2010-11 year.

Origin is happy to work closely with the QCA over the coming months to further explore these options for reforming pricing structures.

- **How should a direct cost pass-through be handled in the context of the Queensland Government's Uniform Tariff Policy?**

The ideal method is obviously for a customer's respective network charges to be passed through directly or indirectly within their retail tariffs. Under the uniform tariff policy, this would only be possible if it was assumed that the policy only referred to the separate energy and retail cost within the retail tariffs.

However, this submission has been written under the assumption that the Queensland Government's uniform tariff policy is maintained and that therefore, the only practical method for improving cost reflectivity of Queensland retail tariffs is by their alignment with south east Queensland network tariffs.

That is, currently, all retail tariffs in other regions of Queensland (Ergon areas) are not cost reflective and do not meet the cost of supply. In the south east region (Energex's area), cost reflectivity of the retail tariffs varies considerably as shown in this submission. Therefore, by aligning the uniform retail tariffs with Energex's network charges you are ensuring that more than half of Queensland consumers are facing cost reflective charges

and it will also improve the cost reflectivity of most other Queensland customers at the same time.

This method would improve retail competition in south east Queensland which, at this point in time, is the only competitive electricity market in Queensland.

An added benefit of this approach is that the CSO or subsidy being provided to each Ergon based customer is transparent as it would equate to the difference between the Ergon and Energex network charges for that customer class, including transmission charges.

This transparency of subsidy per customer may be useful in the future if the Queensland Government wished to provide the subsidies directly to customers or their retailers through alternative methods and enabled retail competition in the Ergon distribution area.

- **What would be the implications for the achievement of cost-reflectivity and demand management if network costs were directly passed through?**

The achievement of cost reflectivity can only be obtained and sustained through the pass-through of network costs directly or indirectly.

Furthermore, demand management will be largely driven by distribution networks and their pricing principles for such programs. Therefore, their pricing penalties for poor demand or benefits for improved demand management can only be exercised if network costs are clearly passed through the retail tariff in a bundled or unbundled manner.

### 4.3 Retail costs and retail margin

The estimation of retail cost and retail margin is difficult to obtain consensus upon because of the various forms such as:

- Is this a second tier or host retailer;
- If standard, are the costs of market customers included;
- What size retailer is considered; and
- What allowance is provided for the retailer to acquire or retain customers?

Similarly, although retail margin is consistently set at benchmark levels by jurisdictional regulators to levels such as 5 per cent of total revenue or 10-12 per cent of controllable cost, there is little to no consideration of whether the regulatory framework in question mitigates or increases retailer risks and therefore whether the 'standard' margin is applicable?

In addition, the margin allowed should reflect the specific characteristics of the:

- particular market including the shape and predictability of demand and the mix of supply sources;
- time at which the pricing arrangements are set, and the quality and level of data available then;
- time period over which the tariffs apply; the longer the time period, the greater the possibility of systemic error; and
- extent to which risks are captured in other components of the price; for instance, whether the energy cost allowance captures market volatility adequately, or whether the retail costs include allowance for debt and counter-party failure.

In summary, there is no “one-size fits all” margin calculation. However, it should be very clear (both empirically and statistically), that the longer the price path period, and the more precise the components of the price path, the greater the risk and the higher the margin.

- **What are the fixed and variable components of retail operating costs and how do these costs vary for customers in different tariff classes?**
- **How should the retail margin for an efficient retailer operating or potentially operating in the south-east Queensland electricity market be determined?**
- **How should the current level of headroom be determined and how should it be factored into regulated retail electricity tariffs to ensure that it remains relatively stable?**

For the purposes of a price determination in 2010-11, Origin is proposing that the BRCI or a derivative of the BRCI continues to be used. This includes using the methodology currently employed for estimating the retail cost and customer acquisition cost within the BRCI.

The current BRCI also uses a benchmark figure for retail margin which has remained unchanged over recent years. Origin concedes that this will be maintained but highlights that if network costs are removed from the BRCI equation then a retail margin benchmark of 11 to 12 per cent of controllable costs should be used rather than the current 5 per cent margin of total revenue.

#### **4.4 Escalation of regulated tariffs**

- **The Authority seeks stakeholders’ comments on whether to continue with a single escalation factor or to apply different escalation factors to different tariffs or tranches of tariffs?**

Whether the retail tariffs are escalated by a single or different escalation factors will be dependent on the improvement in cost reflectivity of retail tariffs that is sought in 2010-11 and hence, the method selected to for the price determination.

If the QCA was to recommend that network tariffs (Energex) are directly or indirectly passed through the retail tariffs in 2010-11 then only a single escalation factor is required to estimate the change in retail and wholesale energy costs for that year.

If other methods which include network charges within the BRCI are used then it would prove beneficial to provide for more than one escalation factor in order for cost reflectivity of retail tariffs to be improved or at least maintained at current levels.

#### **4.5 Achieving Pricing Certainty**

- **What are the benefits and risks of moving to a longer regulatory period from the current annual indexation??**

As already stated, given the current combination of a network price determination and the uncertainty about CPRS, Origin believes it is unworkable to set a three year notified price path in the next 12 months and attempting to do so provides no benefits but many risks. The usual benefit provided by a longer regulatory period is the pricing certainty provided to market participants. In this case, a longer period provides no certainty as all participants

are aware that any determination would almost certainly need to be re-opened in a year's time to take account of the CPRS once its impact is better known.

Once the CPRS legislation is enacted it will take at least a year for the forward electricity curve to stabilise and adequately reflect the price risk of carbon in electricity prices and therefore the cost of energy purchases.

Consequently, in this time of uncertainty, a one year review is appropriate, and Origin believes the QCA should review tariffs for 2010-11 on a single year basis and await further information on the CPRS before contemplating a 3 year price path.

If the alternative was contemplated, the uncertainty of the impact of cost of carbon on electricity prices (before the legislation is passed), would imply a risk premium in the Queensland electricity forward curve which would add to the costs of the notified electricity prices and expose customers unnecessarily to the possibility of higher risk premiums in electricity prices.

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| <ul style="list-style-type: none"><li>• If a longer regulatory period is adopted, how should the prices be set for that longer period?</li></ul> |
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As stated throughout this submission, Origin does not support a longer time period being adopted at this point in time but recommends a single year determination for 2010-11 and subsequently, a 3 year price path determination from 2011-12 onward.

This would provide greater certainty on the CPRS which will have a significant impact on retail prices and will allow further consideration of the appropriate methods to utilise in setting prices.

Once the longer period is viable on the basis of firmer policy settings, improved data and robust methodology then Origin recommends consideration of the options discussed by the AEMC in their recent report.

#### 4.6 Reopening Pricing Decisions under Special Circumstances

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| <ul style="list-style-type: none"><li>• What events, if any, should trigger reopening of a retail pricing decision?</li></ul> |
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Re-opening clauses will be required when the methodology for a longer regulatory price path is set and implemented.

The requirements for a reopening are paramount given the potential impacts of the CPRS and the fact that, even if a 3 year price determination is made in 2011-12 when further information on CPRS is known, there will still be many uncertainties on the market response to the final form of the CPRS. If the 3 year period was attempted now, a re-opening would need to be enacted in 2011-12 which is a major reason for completing only a single year determination for 2010-11.

Origin would highlight that there has been difficulties in other regulatory frameworks in describing and designing precise trigger events for a reopening. Reopenings of themselves are often events that were not expected hence not easily described in advance.

Origin proposes that materiality thresholds are used to trigger re-openings rather than any attempt to describe an unknown event.

- **Should such a reopening be prospective only or seek to recover losses incurred prior to the reopening?**

Origin would highlight that under a longer regulatory period, it would be seeking for any reopening to include recovery of losses incurred prior to the reopening and its resolution.

Origin notes the reopening of the New South Wales regulatory price determination and the extent of retailer losses that can be extrapolated when the findings of the reopened decision are compared with the retail prices that participants were facing prior to the decision.

These losses were never recovered by second tier retailers.