



**Submission to the  
Queensland Competition Authority  
on its  
Draft Report:  
Review of Electricity Pricing  
and Tariff Structures - Stage 1**

28 August 2009



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## Executive Summary

Origin Energy (Origin) welcomes this opportunity to respond to the Stage 1 Draft Report by the Queensland Competition Authority (QCA). Under the terms of reference (ToR) provided by the Minister to the QCA, the QCA is required to examine:

- the existing Benchmark Retail Cost Index (BRCI) methodology for setting notified retail electricity prices and to consider alternative approaches; and
- existing retail tariffs and to consider whether they are cost reflective, provide appropriate signals to customer and what alternative tariff structures might be better.

Origin understands that the main purpose of QCA's Stage 1 review is to examine the BRCI methodology and alternative methodologies and to provide an overview of the existing retail tariff structures. The Stage 2 review will then examine alternative retail tariff structures with the long term objective of managing peak demand and encouraging efficient energy utilisation.

Origin has already responded to the initial QCA Issues paper with two detailed submissions in July 2009<sup>1</sup>. Origin continues to hold closely the views expressed in these two submissions and this response to the current Draft Stage 1 paper should be read in conjunction with the detailed submissions previously provided to the QCA.

Origin acknowledges the very tight timetable that the QCA has been given to respond to the ToR with the aim of completing both processes by November 2009.

Nevertheless, Origin is increasingly concerned at the impact the limited time frame will have on quality of the QCA's review process particularly in the light of the QCA's proposal to implement a 3 year price path commencing July 2010. It is essential that the regulatory bodies including the QCA in its recommendations to government understand and acknowledge that even small errors have, over a 3 year period, major impacts on the viability of retailers, the success of competition and the achievement of the objectives set by the Queensland Government in the Terms of Reference (ToR).

The current Stage 1 Draft Report reinforces these concerns. There is now less than nine months for the QCA to complete the 2 stage review process, for the Government to assess the recommendations and implement the necessary legislative framework and then for the QCA to determine a new 3 year price path in accordance with the final legislative framework.

Origin believes that the Stage 1 draft report leaves many key questions largely unresolved, including the:

- modelling approach to adopt when calculating the wholesale energy costs over a 3 year period,
- the treatment of environmental costs in the energy cost (in particular, the CPRS);
- treatment of network costs, including flexibility to respond to the new network pricing determination that commences in 2010-11;
- treatment of notified prices for large customers (greater than 100MWh/year) who are currently enjoying significant subsidies under the uniform tariff policy; and
- pathway to implementing the multiple retail tariff reforms, given the extent of the issues with most of the existing notified prices.

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<sup>1</sup> Origin Energy: *Submission to the Queensland Competition Authority on the Review of the Electricity Pricing and Tariff Structures*, 17 July 2009; \_\_\_\_\_ *Supplementary Submission to the Queensland Competition Authority of the Review of Electricity Pricing and Tariff Structures*, 31 July 2009.

Origin acknowledges that the current Stage 1 draft report by the QCA discusses most of these issues at a high level. However, Origin would contend that the QCA's analysis is either flawed or inconsistent in a number of areas while in other areas, the discussion is at too high a level to provide meaningful response. Importantly, the proposal regarding treatment of a future carbon scheme has the potential to create significant practical and methodological issues and requires considerably more analysis than put forward in this paper. Origin's views on this and some of the other key areas in the Draft Review paper are expanded in the remainder of this submission.

In general, the Stage 1 Review by the QCA provides little comfort that the QCA has fully appreciated the uncertainties and risks in both the network and wholesale energy cost forecasts particularly in the context of the QCA's recommendation for a 3 year price path commencing July 2010 and a "cost build-up approach.

The QCA's recommendations for a 3 year price path and for the use of a cost build up approach (versus the BRCI's change in costs) requires a much higher standard of statistical and market analysis than was required under the BRCI - for instance, the effect of any systemic errors will be magnified over time.

Origin therefore finds the QCA's proposal to investigate options for a "*simpler modelling approach*", a matter of great concern in this environment of significant change. Already the industry consultation processes that are so important to ensuring the complexities of modelling energy costs during a period of high risk and uncertainty are appropriately captured have been compromised by the aggressive time lines.

In this current submission, Origin has again sought to highlight the nature of these risks and the complexity of the modelling decisions that still have to be made by the QCA. Origin also considers that the introduction of periodic reviews of the wholesale price, while essential, is by no means sufficient to redress all the risks identified in this submission. What is also absolutely essential is to set the price path on sound foundations by the development and implementation of a robust and comprehensive load and price forecast methodology and a clear commitment to a consistent network pass through mechanism based on South East Queensland's network costs.

Given these and the many other issues raised in Origin's previous submissions to the QCA, Origin continues to strongly believe that a 1 year, 3 year approach should be adopted. As stated in previous submissions, the first year (2010-11) should concentrate on addressing the network pricing and retail tariff structure reform process. In this context, a simple approach to calculating changes in energy and retail costs can be reasonably adopted as the risks are constrained to a single year.

Once these reform processes are put in place in the first year, a 3 year cost build up approach can be adopted that continues to reflect movements in the network prices but, most importantly, includes a well supported and comprehensive approach to assessing wholesale energy costs that also includes more reliable data and assumptions about the impact of the carbon reduction programs on the energy markets.

Origin has carefully reviewed the proposal put forward to the QCA by AGL in their Supplementary Submission to the QCA's initial paper<sup>2</sup> and believes it provides a very constructive approach to resolving the legislative framework issues that might be considered an obstacle to the 1 year, 3 year approach.

Origin therefore strongly encourages the QCA to re-consider the benefits of Origin's proposal and the extent to which any residual legislative issues arising from this approach can be dealt with along the lines proposed by AGL.

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<sup>2</sup> AGL: *Further Submission to the Queensland Competition Authority: Review of the Electricity Pricing and Tariff Structures*, 4 August 2009.

# 1. Introduction

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 and believes it is opportune to initiate a broad review process given the problems encountered with the current retail tariffs and the very significant changes that are likely to occur in the Queensland energy market over the next few years.

As part of the review, the QCA released its *Draft report: Review of Electricity Pricing and Tariff Structures - Stage 1 (Draft Report)* on the 18 August 2009 and this Origin submission is in response to the issues raised in this document.

However, as Origin has previously submitted to the QCA:

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.

In this submission, Origin has tried to outline the elements of the current approach that cannot be continued for three years, or even for one more year, given they have undermined the validity and integrity of the notified pricing process to date. Whichever approach the Government selects must rectify:

- retailers' exposure to annual changes in network costs, in aggregate and at tariff level;
- retailers' uncapped exposure to large customers choosing to remain on, or selecting to go on notified prices that do not reflect in any way their cost structures;
- the inadequate recognition of the shape of the load for non-market customers, the volatility of this shape and the costs of managing this shape/price risk;
- the lack of any assessment of the sensitivity, reliability and repeatability of the modelling approaches adopted for assessing energy costs;
- the lack of transparency in the inputs, outputs and the relationships between these and the inadequate analysis of the issues around recovery of carbon costs; and
- the limited consultation processes.

The Queensland Government's Terms of Reference reinforce the need to establish a pricing framework that supports retail competition and continued investment in the energy market. Origin believes these objectives are placed at significant risk under the QCA's proposal to implement a 3 year cost build up approach from July 2010.

## 2. Assessment of the BRCI Methodology

The ToR for the review requires the QCA to recommend a pricing methodology that:

- reflects the costs of electricity supply and incorporates sufficient headroom for retailers to foster a competitive electricity market;
- takes into account the Queensland Government's Uniform Tariff Policy;
- provides pricing certainty with a potential to move to a three year regulatory period from 2010-11;
- Is capable of passing through to consumers the costs associated with climate change policies; and
- addresses the treatment of network costs within the framework of the Uniform Tariff Policy.

The QCA's principal conclusions on these matters is summarised in the box below.

1. The current BRCI methodology is unsuitable for delivering notified prices that recover the cost of supply and a fundamental overhaul of the price setting approach is warranted.
2. The distortions arising from the averaging of network costs across the Ergon Energy and Energex supply areas is exacerbated by the application of a single escalation factor across all tariff groups.
3. The BRCI should be replaced by a cost build-up approach, based on the "N + R" approach, with a 3 year price path commencing July 2010 and featuring both periodic reviews of energy costs and reopening for special circumstances.
4. The potentially conflict between the objectives of a uniform tariff policy and cost reflective tariffs is best addressed by allowing retail tariffs to be linked to costs to supply in the Energex area while continuing to provide a CSO subsidy to consumers in the Ergon distribution area. This subsidy should, however be made transparent to customers in their electricity bills.

### 2.1 Pricing Methodology and the Uniform Tariff Policy

Origin agrees with the QCA's assessment that the policy requirement for uniform tariffs across all of the Ergon and Energex areas makes it difficult for the QCA to recommend approaches such as the weighted average price cap (WAPC) that has been adopted in NSW and the ACT. Similarly, it precludes the even more flexible approach allowed (with significant success) in the Victorian regulated pricing regime prior to 2009.

The WAPC approach provides greater flexibility for a relevant standard or host retailer to adjust individual tariffs within an overall price constraint that applies across all tariffs. However, the effect of this would be that each retailer would have some freedom to vary tariffs in accordance with their perception of the relative costs to supply these tariffs (albeit constrained by the WAPC). The over-riding Uniform Tariff Policy simply does not permit such an outcome. A WAPC approach would still be possible if one retailer or authority was provided with the requirement to construct the tariffs to apply uniformly for all.

However, the QCA has recommended target tariffs based on a build-up of network and retail (N + R) cost components. It is worth noting that while other jurisdictions such as South Australia adopt this type of approach as well, they do so in a manner that still allows the host retailer, to "rebalance" individual tariffs within the overall N + R framework. By allowing the retailer to control these elements of the final price the South Australian approach provides

some additional flexibility to achieve cost reflectivity and reduces somewhat the risk to the retailer of regulatory error.

However, given the Queensland uniform tariff policy, the assessment of cost reflectivity at the tariff level, and of the path to achieve that outcome, must inevitably be in the hands of the pricing regulator rather than the retailer. Origin emphasises that this conclusion also implies significantly more analysis and judgement will be need to be undertaken by the pricing regulator (who bears no commensurate commercial risk) in Queensland than in any other jurisdiction.

Origin find it difficult to see how such a complex task can be effectively undertaken within the time frames available to the QCA, and particularly when it is undertaken in parallel to addressing the other matters that face the Queensland reform process such as the CPRS.

## 2.2 Cost Recovery over Time

The QCA acknowledges that a move to cost reflectivity can only be achieved through a full cost build-up of tariffs that incorporate all the cost elements that would be incurred by an efficient retailer in supplying electricity to customers on each tariff (page 31).

Origin strongly supports this conclusion. However, it is of great concern that the comment appears to be qualified by the QCA's subsequent reference to achieving cost reflectivity "over time" in the event that the "difference between notified prices and efficient costs is significant".

Origin has worked with jurisdictional regulators in a number of instances to enable individual retail tariffs to be adjusted over time. However, it is always in the context that:

- the ultimate objective and time frame for the adjustment is understood and agreed at the outset; and
- the overall margin across all retail tariffs is acceptable at any one point in time, taking also into account the overall level of competition<sup>3</sup>.

The QCA has provided no indication at this point how it will deal with the adjustment of notified prices that are significantly below costs within the overall context of retail tariff reform. However, this is a most important matter of principle when addressing the questions of efficient pricing and cost recovery. Origin considers it is unacceptable that any such adjustment period is adopted unless it is adequately compensated for in other areas during the transition period.

## 2.3 Pricing Methodology

Origin is pleased that the QCA has acknowledged the obligations under the Australian Energy Market Agreement (AEMA) to pass through all carbon abatement costs to consumers.

Origin notes that the QCA has identified the extensive body of expert advice on the potential impact of the CPRS on energy costs and price volatility and on the difficulties of accurately forecasting future carbon prices particularly in the early years of the scheme.

However, the QCA then proceeds to claim that the solution to the questions of volatility and uncertainty lie in developing a "*robust framework capable of managing issues as they arise rather than delaying moving forward for fear of the impact of pending, but at least unidentified, market pressures*" (page 33). The QCA then appears to support adopting an approach currently used by IPART of:

<sup>3</sup> Where competition is high, retail tariff adjustment must be similarly quick to minimize the risk of the retailer with the obligation to offer, being subject to cherry picking of customer segments with higher margins who have been subsidizing lower margin segments.

- conducting periodic reviews of the energy purchase cost component (annually, or biannually during the first year of the planned CPRS); and
- adjusting the price path if (and only if) the outcome of the review of energy costs sits outside a “tolerance” factor of + or - 10% (on the original forecast energy costs).

Origin disputes the QCA’s conclusions on this matter.

While a periodic review of energy purchase costs is necessary (even essential), it is not sufficient as a way of addressing the complex issues of regulatory price control over multiple years and in an unstable and uncertain environment that includes one of the most significant “step changes” in the history of the NEM market (ie the CPRS). Further comments on the CPRS and its impact on the assessment of wholesale energy costs are included in Section 3.6 of this submission.

However, in terms of the overall pricing methodology, Origin would state that at a minimum, the following additional factors must be considered as part of establishing periodic reviews.

### 2.3.1 Characteristics of the modelling framework

*The Modelling Framework:* The framework must be transparent and sufficiently stable and predictable to be used for the planned periodic review processes - this implies that the model had been subject to stress testing, the model algorithms that relate inputs and outputs are transparent and testable and the sensitivities of the outputs to variations in the inputs are clearly understood at the very start of the process. A bad model produces bad outcomes and these are not resolved by simply re-running the model with changed input data at a later date.

*Compensation for Retrospective Error:* The framework must address the issue of retrospective error. In its previous submission Origin highlighted that the IPART approach failed to capture the impact of either the drought induced market volatility or the escalation of LRMC input costs that occurred soon after the finalisation of the previous retail price path. The increases in the 2009-10 allowed energy costs that subsequently occurred in the 2009-10 year in no way compensated retailers for the regulatory error that occurred in the 2008-09 year. As a result there was a progressive decline in market activity in NSW in that year<sup>4</sup>.

*Availability and Quality of data:* The modelling framework must take into account that quality and quantity of data available as input into the model. For instance, a purchase cost model that relies on 2 years of monthly forward purchase data, must consider the question of whether that 24 months of data is (a) available and (b) if it is available, whether it consistently captures the policy factors that influence the forward market.

As an example, will market data (such as d-cypha) for forward contracts in the first half of 2010 for 2012, be either sufficiently available or relevant to calculating the costs of 2012-13 under the CPRS<sup>5</sup>? If the answer is no, then a model that relies on 24 months of data may not be appropriate because it cannot be replicated in future reviews.

### 2.3.2 Characteristics of the Periodic Review & Pass-through Events

*Frequency of the Review:* Origin agrees that there should be a minimum of an annual review with six monthly review associated with the introduction of the full CPRS (because of the

<sup>4</sup> The NSW standard retailers were largely protected because the Energy Tariff Equalisation Fund was still operating at 100%. Without this, there would have been very significant losses to the standard retailers in NSW in the 2008-09 year.

<sup>5</sup> This issue also relates to a concern raised elsewhere in this report regarding QCA’s recommendation to project prices on the basis of no CPRS, and “add in” CPRS if/when it occurs.

general uncertainty and impact of monthly permit auctions). The question remains, however, if additional opportunities should be provided.

*The Level of the Threshold:* An error threshold (such as the +/- 10% threshold proposed by the QCA for energy costs) cannot be set in isolation, but must be understood in the context of the retail margin and the statistical characteristics of the model itself including the range and distribution of errors in the forecast component and model and any propensity for bias in the error.

For example, the +/-10% threshold effectively translates into a range of +/- \$6/MWh around the forecast wholesale energy cost, before a review is undertaken. This \$7/MWh is far too high in the context of a retail margin of around 5% return on sales given a 5% return on sales equates to approximately \$6/MWh retail margin. The risk/reward equation, particularly in the context of the overall market volatility and change, is commercially unrealistic and undermines the viability of the competitive market.<sup>6</sup>

In addition, the use of a +/-10% threshold conveys the impression that the forecast errors over each of the 3 years of the price path are normally distributed around the regulators forecast point. However, it is quite feasible (even likely) that the errors will arise from a systematic bias.

If the modelling framework has a systematic bias in its specifications or data sources, then the retailer may be subject to cumulative risk where each year the WEC increase is below the 10% threshold. Simplistically, retailers in general could lose some \$42M in one year and over \$120M over 3 years in the event of a biased but limited error in the energy cost calculation of the underlying model<sup>7</sup>. Equally, the statistical bias might come at a cost to consumers. This is also unacceptable.

*The Scope of the Periodic Review:* The QCA has recommended that the periodic review only apply to the wholesale energy costs component of the retail price path. This is similar to the approach previously adopted by IPART.

Origin believes this may be inadequate for the purposes of the next 3 year period, depending in part on the parallel treatment of pass-through events. In particular:

- given the expansion of the RET program, and the expected surge in RET costs, errors in the forecast of RET costs may be significant and warrant being part of the annual review;
- changes in energy losses (DLF and TLF) from year to year should be taken into account in the annual review.

The opportunity to recover costs associated with additional regulatory events such as those related to the smart meter program<sup>8</sup> should be allowed in the review or under the pass-through events arrangements.

More generally, if the QCA proposes to use a modelling approach that relies largely on external market data to generate energy load and price forecasts, then the question arises about the integrity of the review process itself. If for example, the 3 year price path is set on the basis of forward contract data available at a particular time, then these assumptions are to some extent locked in, the review cannot be used to impose perfect “hindsight” when the reality is that a prudent retailer will have locked in contracts for a proportion of their

<sup>6</sup> Origin highlighted in its previous submission, the effect that this had in 2008-09 on competition in the NSW energy market, as the review process and threshold failed to adjust retail prices to the significant changes in the wholesale market.

<sup>7</sup> Based on a total of 1.2M customers with average use of 7MWh per year, and an average WEC of \$60/MWh (illustrative only). A +/-10% error in the WEC is equivalent to \$6/MWh forecast error. If the actual error was \$5/MWh then it would pass the threshold test each year while still creating significant risks that may not be offset the following year.

<sup>8</sup> For example, the AEMC is currently considering costs pass-through arrangements for LNSP’s associated with the national smart meter program and pilots and trials for this program. It has been suggested, however, that retailer costs should be recovered through the jurisdictional processes.

load based on the knowledge available at the time. A further explanation of this is provided in section 3.6

## 2.4 Network Cost Pass-Through Arrangements

The QCA has recommended the adoption of an “N + R” approach. In its discussion on the “N + R” approach, the QCA has suggested that a key benefit of this approach is that it ensures “*network costs are fully recovered*” (page 31) and “*will provide the flexibility to ensure that regulated tariffs remain as cost reflective as possible each year and also provide maximum price transparency and stability*” (page 43).

Origin generally supports this approach. However, we would seek clarification on a number of matters from the QCA.

For instance, the QCA also notes that as a new AER determination in respect of distribution network costs is due to take effect from 1 July 2010, it would seem appropriate that “*this would trigger a review of notified prices if proposed costs that are materially different from the costs estimates already included in the prices*” (page 35).

This last statement from the QCA seems to imply that the QCA will:

- attempt to forecast the network costs by tariff level, prior to the finalisation of the AER decision and the subsequent publication by Energex and Ergon of the individual network tariffs; and
- adopt a “materiality” test when considering the impact of the final network tariffs on the retail prices.

This is not tenable and raises many questions as to why the QCA would consider recommending a 3 year price path when in all likelihood it will be required to reopen any decision in May 2010 when network prices are finalised.

Furthermore, Origin would like to understand:

- Is this “materiality test” limited to the first year 2010-11, or will it be a feature of tariff setting each year;
- How does the QCA propose to forecast these network prices in aggregate and at the tariff level? It is very clear that both Energex and Ergon are likely to obtain approval from the AER for significant increases in network tariffs, and that they will use this opportunity to restructure network tariffs;
- What will be the basis of this “materiality” test and how does this test relate to previous statements (page 31) by the QCA to allow “full” pass-through of network charges? We seek confirmation that any residual mis-match risks on network costs arising from this materiality test process will be compensated for in the retail margin; and
- Why is there a need to “review” the notified prices at all given the separate recommendation on page 45 of the Stage 1 Report that network charges should be passed directly through to the customer?

With respect to this last point, Origin would also highlight that most retail billing systems for mass market customers are not set up to have a separate pass through of network charges. It is likely that implementation of such an approach would be very expensive as it would require the retailer to modify all its billing and other customer systems to undertake a new and separate series of calculations for each bill (to assess individual network charges for that customer), in parallel to the calculation of the retail costs. As network charges become more complex, and move away from simple volume calculations, this is even more of a challenge.

Origin therefore strongly recommend that QCA consider the approach adopted by ESCOSA in which the retail and network components are separated in the initial mandatory publication

of the tariffs, but billing is based on the combined “N + R” price (which is also published at the same time as the component parts).

## **2.5 Uniform Tariff Policy (UTP)**

Origin appreciates the practical difficulties created for the QCA by the Government’s policy commitment to a UTP across all Queensland, notwithstanding the significant differences in both network and energy cost structures to supply customers on notified prices across the State.

Origin supports the QCA’s view that the objective of achieving cost reflectivity in South East Queensland is more critical at this point in time than providing network price signals to Ergon’s retail customers. Origin’s view is that any price signals to Ergon retail customers are so muted by the overall subsidy to these customers that any significant impacts on consumer behaviour will be very small.

Moreover, the most fundamental network costs issue is the signalling of the very different costs of peak and off-peak usage to the network (an issue which applies equally to Ergon and to Energex) and this may well be signalled in the retail prices set on the basis of costs to supply in the South East Queensland area.

Origin also agrees with the QCA’s recommendations that current arrangements whereby Ergon Energy Queensland receives a Community Service Obligation (CSO) payment should continue. The QCA’s recommendation that this CSO should cover both network cost differences and energy cost differences is also most appropriate.

However, while providing transparency of the CSO is an good idea, Origin consider that there may be many practical barriers to the proposal by the QCA for Ergon retail customers to show on a customer’s bill both the actual Ergon network charge and the subsidy. The benefits would need to be carefully assessed against the implementation costs.

## **2.6 Access to Notified Prices by Large Customers**

As highlighted by the QCA, under the current legislative framework, large customers over 100 MWh can remain on a notified price, providing they have not previously taken up a market offer. In addition, any new large customer has the right to access a notified price. Many new large customers in South East Queensland have taken this opportunity to seek protection from paying cost reflective prices on offer in the market.

This has been a particular issue over the 2008-09 year, where retail prices notified prices were set at levels significantly below the relevant costs to supply.

At this time, there are no indications that the policy will be revised notwithstanding the inefficiency and lack of equity in the outcomes - for example a new manufacturer will have the opportunity to have lower energy costs than an existing manufacturer who in good faith accepted a market contract in the 10 years since the market was opened to large customers and competitive offers first became available.

### 3. Energy Cost Methodology

The QCA has recommended the following high level approach for a 3 year price path:

1. The use of a purchase cost methodology for calculation of wholesale energy cost component; and
2. Maximum use of publically available data.

Origin generally supports the principles that underpin the recommendations by the QCA. However, Origin emphasises that there is considerable work to be undertaken before such principles can be developed into a sound methodology that can be applied across a 3 year period. Origin would further emphasise that:

- a move to a cost build-up approach within the 3 year price path places an even greater requirement on establishing a sound methodology that adequately captures the complexity and risks facing a market in transition; and
- the risks associated with the limitations in the methodology itself, are not redressed by regular price reviews, particularly if (as suggested by the QCA) the review provides only a limited review by updating with market price data.

In this context, Origin is therefore most concerned at the QCA's proposal to "*investigate potential options for adopting a simpler modelling approach that can be undertaken using as much publicly available data as possible.*"

While the QCA's desire to seek a simpler modelling approach may have some immediate appeal given the problems with "black boxes", there is a very significant risk that in the search for simplicity, the real costs and risks to a retailer are not captured. This would have serious consequences in the Queensland energy market over a 3 year period. Origin believes that the QCA has seriously underestimated the complexity of the analysis required to establish a methodologically and empirically sound approach to forecasting wholesale energy prices.

As a consequence, the QCA has also understated the time required to achieve an outcome that provides a fair and sustainable return to retailers for risk, promotes competition and is in the long term interests of consumers.

The discussion below identifies a number of the positive aspects of the QCA's Stage 1 draft recommendations, but also highlights some of the complexity that is not addressed in the QCA review but should inform the consideration of whether the QCA's proposed approach is appropriate at this time.

First, Origin considers that the QCA has rightly decided not to use a 50% weighting of both Long Run Marginal Costs (LRMC) and purchased costs, but has instead recommended a market based approach verifiable by published forward curve data. However, Origin would note the following important limitations:

In the context of a 3 year price path, the concept of LRMC should not be abandoned entirely. That is because the LRMC does perform one fundamental function, it determines the cost of entry for generation plant to cover the regulated load shape and therefore sets a floor on the cost of energy. This is similar in principle to the use of LRMC by Frontier in IPART's determination approach.

Origin highlights that the use of a LRMC (properly specified) as a floor to the energy cost calculation is particularly critical in the context of a 3 year price path as the regulator's determination on the energy cost allowances sets the signal for investment in generation

infrastructure. If the energy cost allowance is too low, retailers will be hesitant to contract and investors reluctant to build.

The introduction of CPRS also impacts on the LPMC and the investment in low carbon emitting generation will also require that a carbon-inclusive LPMC sets the floor (see also discussion on carbon pricing in Section 3.6).

Generally, Origin supports the use of publically available data as much as possible. However, in the context of the step change in the energy market it is essential that publically available data is critically examined for its relevance and quality. Simply because the data is available does not make it useful or valid for decision making, particularly in an era of change. For instance, market data that is derived from an illiquid market may consist of small, specialist trades and not be relevant to costs facing a retailer purchasing a substantial volume to service mass market load - sellers of contracts will, in a period of uncertainty, regard large sales to such a retailer as having a high degree of risk and will price this into their contracts accordingly.

There are many aspects of the purchase cost methodology which still need to be considered by the QCA, and it is difficult to provide unqualified support to the QCA's approach in the absence of any of this detail.

For example, a purchase cost methodology might use a similar approach to that previously adopted by CRA, which uses market based forward curve data to establish the basic purchase cost parameters (to which they add shape and volatility risk). In contrast, Frontier uses market data but generates its own modelled forecast price curve and cap costs to establish the basic wholesale energy cost parameters.

In general therefore, the risks a retailer faces that the price determination will not cover costs is greater the longer the price path. The risk inherent in being an electricity retailer increases, as well as exposure to a volatile forward curve, and the risk that the market will restructure or face a step change such as the introduction of the CPRS legislation.

The current one year price path reduces a significant part of the unknown component of this risk. It is of concern to Origin that the QCA intends to push forward with a three year price path before a better understanding of market risks imposed by the introduction of CPRS are known.

Origin is not convinced that a three year price path with reviews reduces these risks because the final price path is subject to the effectiveness of the review process. Since the QCA has not fully described the mechanics of the review process, Origin is not sure what it will constitute and therefore cannot properly value the risk going forward.

Other critical areas of risk discussed below, are similarly exacerbated by the fact that the QCA is suggesting a 3 year price path commencing in 2010 (when many key aspects of the step change will still be uncertain). The proposed move to a cost build up approach means even more attention must be paid to the assessment of and pricing in of the risks associated with the key parameters listed below, including the:

- relevant load shape that will be subject to the forecast analysis;
- forecast approach to that load shape;
- forecast market prices and load/price matrix; and
- treatment of load and price risk.

The QCA has provided no recommendations in the Stage 1 Report on any of these matters, and Origin is most concerned that the QCA might not have fully accounted for their complexity when concluding that a 3 year cost build up price path can be established and implemented over the next 6 to 9 months.

### 3.1 The Relevant Load Shape

The load shape is one of the two most important aspects of the calculation of wholesale energy costs, and a retailer goes to significant effort to understand and forecast this load shape. Errors in load shape forecasting, or misunderstanding of the associated risk will have severe impacts on a retailer's financial viability in a market where the wholesale prices can reach \$10,000 MWh (this figure may be even higher during the course of the 3 year period).

The relevant load shape was a significant shortcoming of the existing BRCI. Following the Supreme Court case, the BRCI was based on two load shapes. The purchase cost was calculated on the basis of the combined load shape of the Energex and Ergon distribution areas (excluding direct transmission customers and load outside the NEM regions) and the LPMC was based on the total Queensland load (excluding load outside the NEM regions).

Neither of these load shapes accurately reflect the costs associated with the supply of electricity to notified pricing customers across the state, and more particularly, in the South East Queensland region. As a result, the true costs of supply to retailers in South East Queensland are significantly understated.

This matter is not discussed at all in the Stage 1 report, yet it is fundamental to a cost-build up approach to the calculation of retail tariffs (it was somewhat less important in the context of the BRCI which assessed changes in energy costs, not the absolute value of energy costs).

Origin considers that the relevant load shape for the purposes of implementing a new cost build up approach must (at least) be the Net System load Profile (NSLP) for South East Queensland customers. While this is still not representative of the load serviced under the notified pricing regime (as it includes Large Customers on market prices) it is probably the nearest shape that is objectively available.

Origin note that the inclusion of large customers under the notified pricing regime complicates the decision on the correct load shape to use, and on the forecasting of the load shape as discussed below.

### 3.2 Forecasting Load Shape

If the QCA is to implement a 3 year cost build up approach, considerably more analysis needs to be given to the issue of forecasting this load shape over a 3 year horizon (and longer for the LPMC calculation).

Again, the QCA provides no insight into their views on how this might be undertaken. Origin is most concerned that the restricted time available to the QCA may put at risk achieving a robust 3 year forecasting methodology and outcome.

Critically, in adopting a cost build up approach, which in turn requires the use of an appropriate load shape (such as the NSLP as indicated above), the QCA cannot then rely on publically available forecasts such as the SOO forecast (although it might provide a useful check).

In the context of a cost build-up approach, the QCA's previous view that a more appropriate load shape (such as the NSLP) cannot be adopted because of the lack of externally recognised load forecasts should be set aside. Instead, if the QCA is to adopt a new 3 year cost build up approach for 2010-11, then appropriate attention has to be given to the development of a robust forecast of NSLP demand in South East Queensland for each of the three years.

The forecasts must include the three essential forecast parameters of aggregate load, peak demand and the shape of demand, including (inter alia) intraday shape, day type and seasonal swing.

The importance of forecasting beyond aggregate and peak load to include accurate forecasting of load shape becomes clear when considering that market based pricing models seek to establish some form of price/demand correlation matrix at the half hour level. This matrix must represent a realistic response of half hourly price to half hourly demand, using historical relationships to forecast future relationships. Detailed examination of the available information on the load and price traces from the current BRCI indicates that these types of modelled outcomes can significantly affect the overall pricing outcomes<sup>9</sup>.

In addition, to establish true cost reflectivity, the forecasts must be further segmented into market segments (eg residential, small commercial, large commercial, industrial >100MWh in South East Queensland), and provide a separate forecast of controlled load demand under the various controlled load tariffs such as Tariff 31 and 33.

### 3.3 Forecasting Market Prices

The QCA has indicated its intentions to use published data to the maximum extent.

Origin has noted that care must be taken in using such data in the context of limited liquidity and a step change in the market structure such as will occur under a CPRS and expanded RET program.

The current BRCI price setting process calculates the year on year change in the cost of energy. The price risk associated with purchasing electricity contracts is not really an issue because the 24 month fluctuations in the price of flat, peak and cap contracts for the prompt year in question are substantially known. Given the uncertainty over the next few years regarding CPRS and its impact on the forward electricity curve, the contract price volatility risk can be minimised by only setting tariffs for one year.

However the contract price risk of setting 3 year price paths, at a time of step changes in contract prices due to CPRS is significant. Given a 24 month contract purchase window, a three year price path is set without knowing 12 months of the fluctuations in the second year contract prices and none of the third year contract price fluctuations.

To cover this price risk, a premium should be applied ex-ante to the cost of energy as a volatility premium or in the retail margin; or there should be a re-opener allowed ex-post if the cost of energy deviates from the expected price path.

The QCA has suggested that it will cover this price risk with an automatic review once CPRS is implemented. However retailers still need to contract forward and will do so on the basis that the automatic review will compensate for actual costs. An automatic review contains inherent risks that contract costs will be compensated in hindsight, which is not the risk retailers actually face. A retailer is trading forward now and taking risks about how the curve will change once CPRS is introduced.

### 3.4 The Contract Portfolio

A shift from a 1 year BRCI to a 3 year cost build up approach will require much more consideration to be given to the structure of the retailer's hedging portfolio and how this is optimised over time and in the face of a step change in the market.

For example, the questions of:

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<sup>9</sup> Origin has examined the available data from the 2008-09 BRCI, and the preliminary data used in the 2009-10 draft BRCI determination, and found a number of unlikely outcomes where high demand correlated with low prices and vice versa. While no such data is available for the Final Determination for 2009-10, it illustrates the importance to the integrity of the final outcomes that there is transparency in the inputs and modeling details.

- what mix of flat and peak swaps, caps and other hedging instruments is consistent with an efficient stand-alone retailer's activities;
- what portion of the forecast load should be contracted; and
- how will this change over a 3 year period?

The QCA has again provided no indication of how these important matters will be addressed, yet over a 3 year period, the assumptions around the contract portfolio will have important effects on the outcome. It is unlikely mistakes in the specification of the portfolio mix will be redressed by any automatic review.

### 3.5 Load and Price Swing Risks

#### 3.5.1 Contract price risk

The current BRCI price setting process calculates the year on year change in the cost of energy. The price risk associated with purchasing electricity contracts is not really an issue because the 24 month fluctuations in the price of flat, peak and cap contracts for the prompt year in question are substantially known. Given the uncertainty over the next few years regarding CPRS and its impact on the forward electricity curve, the contract price volatility risk can be minimised by only setting tariffs for one year.

However the contract price risk of setting 3 year price paths, at a time of step changes in contract prices due to CPRS, is significant. Given a 24 month contract purchase window, a three year price path is set without knowing 12 months of the fluctuations in the second year contract prices and none of the third year contract price fluctuations.

To cover this price risk, a premium should be applied ex-ante to the cost of energy as a volatility premium or in the retail margin; or there should be a re-opener allowed ex-post if the cost of energy deviates from the expected price path.

The QCA has suggested that it will cover this price risk with an automatic review once CPRS is implemented but retailers still need to contract forward and will do so on the basis that the automatic review will compensate for actual costs. An automatic review contains inherent risks that contract costs will be compensated in hindsight, which is not the risk retailers actually face. A retailer is trading forward now and taking risks about how the curve will change once CPRS is introduced.

#### 3.5.2 Load shape and load swing risk

The BRCI methodology recognised load shape risk but did so on the basis of a load that was not representative of the load of customers subject to or eligible for a notified price.

When a cost build up approach is adopted the question of forecasting load shape will take on even more importance. As indicated previously, the starting point for minimising this risk is to forecast the load shape on the basis of the NSLP. In addition, however, there will need to be an assessment of the risks around this forecast and how these risks might change over time.

The objective and transparent evaluation of this shape risk will be central to the relevance of the modelling exercise.

Origin also believes that the BRCI totally undervalued the load swing risk inherent in the cost of energy calculation and this must be addressed in any new cost-build up approach<sup>10</sup>. For example in the 2009/10 BRCI Final Decision the difference between the cost of energy for the 10POE demand and the 90POE demand was only \$0.29/MWh, even after the QCA changed to

<sup>10</sup> Again, it is important to note, this is less of an issue in the context of the BRCI as the driver of the retail price movements is changes in costs not the absolute value of the costs.

the peakier NEM Load. Intuitively, and from Origin's own analysis, a differential of \$0.29/MWh between hedging a 10POE versus hedging for a 90 POE load must undervalue the risk premium paid to manage 1 in 10 demand.

The QCA's modelling incorrectly assumed that periods of high demand were not correlated to price (see above), and therefore calculated a return on cap contracts that was unrealistic. i.e retailers were long when prices spiked in low demand half hours and short when prices were low in high demand half hours. In comparison to the QCA implied high return on caps, retailers normally value the net return on caps at zero because at times of high pool prices retailers are paying this return on bought caps out on the other side in pool payments to cover the increased regulated demand.

Moreover, there is no apriori reason for selecting a 1 in 10 demand as the appropriate reference point for a prudent retailer with an obligation to offer. As no retailer (or regulator) can accurately forecast demand in a given year<sup>11</sup>, decisions will have to be made about the appropriate reference point based on, amongst other things, the value at risk relative to the load, retail margin and capital base of the company.

In Origin's view, a retailer that is required to provide a free option to customers exercising their reversion rights and with a general obligation to offer, including obligation to offer to Large Customers, must take a conservative view of load swing risk. There needs to be an explicit risk premium in the 3 year price path to recover the cost of customers returning to tariff from competitive prices.

### **3.6 The impact of the CPRS**

The CPRS (and to some extent the expanded RET) have been identified by the industry generally as a major risk for regulatory pricing. Jurisdictional Ministers have therefore made a commitment to ensure that the costs of the CPRS are passed through to end-use customers.

The challenge for the QCA is how to do this, particularly at this point in time where there is considerable policy and regulatory uncertainty around the scheme. As noted in section 2.3 of this submission, the QCA proposes that these substantial risks can be managed by establishing a robust framework, and dealing with issues if and when they might arise.

Origin would agree that a robust framework is an essential, if not a sufficient condition. However, the proposal for a robust framework by the QCA appears inconsistent with the QCA's other recommendation to construct a simple model relying largely on external data sources.

Indeed, Origin do not believe a robust model can be constructed over the next few months without an understanding of the basic characteristics of the proposed CPRS and without a thorough investigation, in collaboration with the industry, of the data and methodological issues associated with fully capturing the carbon scheme's costs.

This issue, which has been raised in various sections of this submission is demonstrated by the example below that considers the risks from the perspective of a modelling framework that relies largely on publically available market data (such as d-cypha data).

The starting point is the recognition that all energy cost forecast models based on publically available market data are likely to implicitly include the market's assumptions (at various points in time) about the impact of the eRET and CPRS<sup>12</sup>. The prudent retailer will be

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<sup>11</sup> Albeit there can be better or worse methodologies, as noted in previous sections, there will always be errors associated with actual weather outcomes etc. That is why it is essential to understand the statistical characteristics of the forecast model.

<sup>12</sup> Although a carbon only market is likely to develop over time, in the period in which the QCA is making its determination, this market will be at best immature and lacking sufficient liquidity to support the hedging requirements of a retailer to mass market customers.

required to purchase forward contracts for 2011-12 and 2012-13, the price of which will include the seller's view of carbon costs and risks for those forward years.

This is illustrated in Table 1, which summarises (in a theoretical sense) the data that will be available to the QCA to make their initial pricing determination for a 3 year period.

**Table 1: Data available at the time of finalising a 3 year price path from 2010**

	2010-11	2011-12	2012-13	Comment
Scenario	No CPRS, eRET	\$10 carbon cost	Full CPRS	
Proposed Market Forecast Model	24 months forward contacts	24 months forward contracts	24 months forward contracts	
Availability at Start of Price Path (eg Mch 2010)	April 2008 to March 2010	April 2009 to March 2010	Nil	What price will be assumed for 2011-12 and 2012-13 & how calculated?
Number of mths of forward data	24 months	12 months	Nil	
Liquidity in the Mkt over the period	Variable over the 24 mth	Variable over the 24 mths	Nil	Liquidity will reflect policy uncertainty & changes in policy
Market Assumptions about CPRS & eRET	Variable over 24 month period	Stabalise after May 2009	Not applicable	Assumption will be built into the contract prices

It is clear from this table that if the QCA uses a simple forecast based on market data, there are many assumptions that will have to be made. In particular, there is no simple way to back out the carbon component of the forward contract market that is embedded in the contract price.

As described previously, an alternative to using a market based approach to forecast energy cost is the use of model generated forecasts as constructed by Frontier Economics for IPART. Such an approach allows the modeller in theory to exclude the impact of CPRS in future years (until the policy framework is in place). However, the outputs of an approach that attempts to model a "no carbon" world will become increasingly abstract and, more importantly, become completely removed from the reality facing a prudent retailer seeking to hedge their position in the real world which has built in CPRS assumptions into the wholesale market prices.

Origin believes there may be merit in running both a market based and model generated forecast in parallel, with the theoretical component acting to stabilise fluctuations in the market, in some ways similar to running a LRMC to set a floor to the price. Origin raises these issues, not because they are insoluble, but to illustrate the complexity of the question of dealing with the CPRS within the context of a 3 year price path, particularly given the commitment to ensuring these costs are passed through to customers. The analysis also illustrates the absolute importance of having the time to conduct a thorough investigation of the modelling and data issues. We do not believe the QCA has provided for this or has been allocated the time to do so.

## 4. Retail Costs and Retail Margin

The QCA has recommended the following:

1. The continued use of benchmarking, potentially supplemented by a “bottoms-up” approach based on a “representative retailer”, with a constant escalator;
2. The exclusion of customer acquisition costs, with inclusion of “normal” marketing expenses in the retail operating costs;
3. Retail margin to reflect the reasonable costs and risks to which the retailer is exposed; and
4. Explicit consideration of “headroom” and the trend in this since FRC.

### 4.1 Retail Operating Costs

Origin has stated from the commencement of the BRCI process that the retail costs applied by the QCA did not reflect the true operating costs of a retailer in Queensland. Nevertheless for the purposes of the BRCI type process, the absolute value of the retail operating costs was not a major issue.

Given the QCA is recommending a move to a cost-build up approach, a commensurate focus on the proper assessment of retail operating costs is now required. This must begin with the clear definition of the relevant retailer starting with the recognition that this must be a stand-alone retailer of at least a reasonable size, managing a portfolio of regulated customers and investing in robust risk management and compliance processes and subject to the prudential and commercial requirements of the investment market place.

### 4.1 Benchmarking:

The definition of the relevant retailer in turn defines the reference point for any benchmarking exercise. It is essential that the only “benchmarks” used in the analysis are those that:

- relate to comparable retailing environments (as defined above);
- clearly define what is included and excluded in the retail operating costs allowance, including the provisioning for bad debts;
- make adequate provision for costs associated with wholesale trading, risk management and compliance processes; and
- have comparable levels of regulatory obligations.

In addition, benchmark costs will have to be adjusted to the particular circumstances and priorities of Queensland market. For instance, if B2B procedures were more complex or performance requirements were significantly different from the norm.

Additional factors that may make the use of historically based benchmarks more problematic (unless adjusted appropriately) include:

- Environmental legislation: In addition to the pass-through costs, environmental legislation requires significant investment in internal systems and processes, reporting and compliance systems and risk management systems (eg for managing REC or Carbon obligations). All of these will add to retail operating costs when compared to previous benchmarks;

- Smart Metering programs: Retailers incur significant up-front and ongoing operation costs in association with smart meter programs, as well as costs associated with supporting proposed “pilots and trials” by the networks; and
- Major system upgrades: The increasing demands on retailer systems with the extension of retail competition, environmental legislation, reporting requirements, complex data etc mean that most retailers have needed to upgrade all their systems from the legacy systems they inherited before FRC. While network determinations typically allow for the amortisation of these costs, they are not explicitly recognised in retail operating cost benchmarks.

## 4.2 Bottoms-up Approach

Although there is some appeal in supplementing a benchmarking approach with a “bottoms-up” approach based on real costs of a representative retailer and in the right circumstances, it can provide a useful supplement to benchmarking approaches.

However, Origin suggests that the QCA undertake further investigation of this option so that its value and limitations are clearly understood. It is our experience that regulators have found such data of limited value due to differences in definitions, treatments of cost allocations, different approaches to depreciation etc.

## 5. Customer Acquisition Costs (CAC)

As stated by the QCA, customer acquisition and retention costs refer to the costs involved with acquiring new customers, retaining existing customers and transferring existing customers on notified prices to market contracts.

Origin agrees generally with this definition but is concerned with the QCA’s subsequent recommendation to remove the explicit allowance for customer acquisition costs.

The QCA’s explanation of their recommendation does not appear to Origin to be consistent with the definition. There appear to be two elements in the QCA’s approach, being:

- the ICRC excluded acquisition costs in its 2009-10 determination on the basis that the “*ACT market was unlikely to experience further growth in competition*”; and
- a relatively large proportion of Queensland customers are already on market contracts.

Origin would contend that the ACT market represents a very special case, and the ICRC’s decision, which applies only to one year, reflects the very particular structural issues in that market that inhibit new retailer entry. These limitations do not apply to the south east Queensland market.

The fact that many Queensland customers are already on market contracts does not appear to us to be relevant. Indeed, Origin considers it demonstrates the alternative proposition that in order to sustain competition over the longer term, allowance must be made for CAC costs. For instance,

- retailers already in that market must continually invest in customer acquisition if they are to maintain their viability and scale benefits; and
- new entrant retailers must innovate and invest to gain entry and successfully compete.

Moreover, the costs of maintaining a competitive market position include much more than marketing costs. There must be continual investment in systems, processes, people and training simply to sustain a retail business.

These “competition” costs associated with maintaining and sustaining the retailer’s customer base must be recognised in the overall cost build-up, whether as an incremental component of retail operating costs or in a separate CAC allowance.

## 6. Retailer Margin and Headroom

Origin appreciates that the QCA accepts that the retail margin needs to be set to reflect the reasonable costs and risk to which the retail business is exposed and notes the QCA’s proposal to investigate further the options for setting retail margin. Origin agrees with the QCA’s concern to ensure there was no “double counting”.

In its previous submissions, Origin has set out some of the important considerations in assessing retail margins. They include the nature of the market, the context in which the pricing framework was established, the period of the price path and the extent to which risks are captured elsewhere in the determination.

In addition to this, Origin urges the same caution when using benchmarks for retail margin as we encourage when considering benchmarks for retail operating costs. For a regulatory benchmark to be useful to the QCA’s determination, it must be one that has been set for a retailer of similar characteristics operating in a market with similar characteristics to the Queensland market.

For example, historical margin benchmarks, such as those in NSW, are of limited value as the NSW energy market for standard customers was supported by the ETEF scheme which removed the majority of load and price risk in servicing standard retail customer from the retailer’s book. Moreover, the NSW retailers were in the past closely linked to their network businesses and, being government owned, had different requirements in terms of return to shareholders.

The QCA has also noted its obligation to ensure sufficient headroom - defined as a “premium” above the economically efficient retail margin - to encourage competitive retail electricity market activity.

Origin would highlight that the principal method for encouraging retail competition is to ensure that the allowances for retail costs and margin and wholesale costs fully capture the costs and risks of the relevant retailer and that there is an effective pass through of south east Queensland network costs.

However, it is also true that beyond the recognition of fundamental costs, the existing of retail headroom in the notified prices will accelerate competition and the move to market prices. It has been reinforced in several submissions over the last few years that the risk of this approach to customers is small as where prices are above efficient prices, competition will ensure customers have choice. In support of this, Origin notes that in the initial year of FRC, there were multiple retailers offering competitive discounts but these have declined in number and quantity since the compression of retail margin and headroom, particularly in 2008-09.

The QCA has, however, highlighted the concerns that some customers will pay additional costs as they have no choice to pay notified prices. There are two matters arising from this claim:

- it has not been demonstrated that any particular segment in south east Queensland has not had access to market offers if they choose. The fact that 3 years after FRC commenced, the QCA estimates that some 68% of customers in south east Queensland are on market contracts demonstrates the wide spread availability of these offers. Origin also comments that in jurisdictions where this question has been specifically investigated, there has been no evidence of lack of access to market offers by particular customer segments; and

- it is true that many customers of Ergon outside the south east Queensland area do not have access to market offers. However, it is also well established that the existing retail tariffs are below (usually significantly below) cost reflectivity. It is therefore also true that Ergon customers, subject to notified prices that are set to recover south east Queensland costs including headroom, will still be paying below the true costs of their supply.