

22 January 2013

Mr Gary Henry
Queensland Competition Authority
GPO Box 2257
Brisbane QLD 4001

Dear Mr Henry,

**Supplementary Submission on the Queensland Competition Authority's ("QCA")
Regulated Retail Electricity Prices 2013-14 Cost Components and Other Issues
consultation paper ("Cost Consultation Paper")**

Origin appreciates the opportunity to provide a supplementary submission to the QCA's Cost Consultation Paper. Recent events in the Queensland wholesale electricity market highlight the volatility of the wholesale spot market, its impact on the Futures market and the potential impact on retail tariffs and retailers given the methodology currently proposed by ACIL Tasman.

Wholesale Market Impacts

The recent price volatility in the QLD electricity spot market has been occurring since 10 January 2013. Prior to this, the period from 1 July 2012 to 9 January 2013, the Queensland spot market averaged \$56.43/MWh; in the 11 days from 10 January to 20 January 2013 the average price has been \$248/MWh. Every day this occurs adds around \$0.52/MWh to the annual price – the 11 days of volatility have so far added approximately \$5.76/MWh to the annual average spot price – an increase of 10.2% - with no immediate sign of abating.

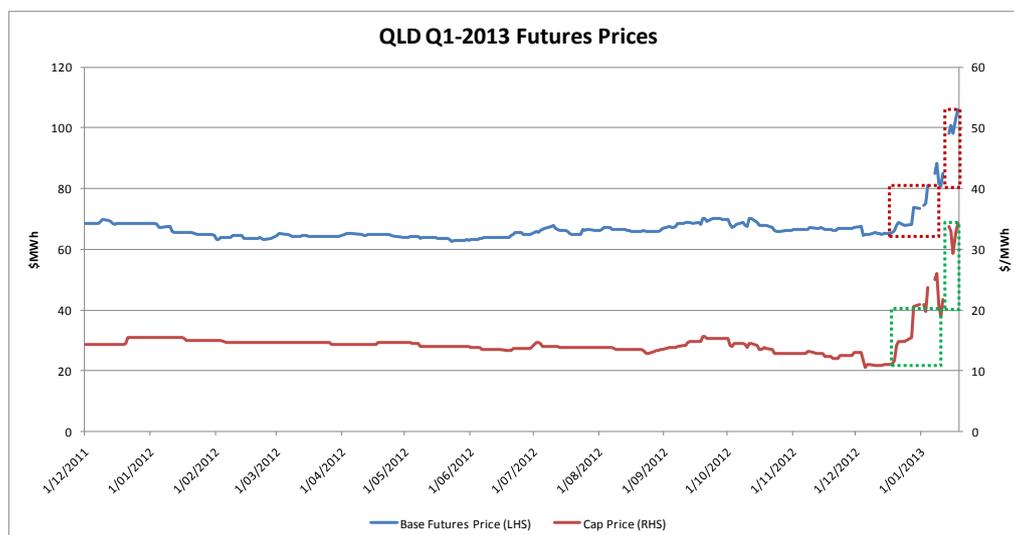
At the same time, the Q1-2013 (Jan-Mar 2013) Queensland Futures Base contract has risen approximately \$20/MWh since 10 January 2013 and is currently trading above \$100/MWh in response to these spot price conditions. Each day of this volatile pricing adds approximately \$2.08/MWh to the Q1 Base Futures price. The current Q1 Futures Base price is 48% higher than the \$67.68/MWh allowed for in the FY2013 Determination.

Similarly the Q1-2013 Futures Cap contract price has increased from \$20/MWh to over \$34/MWh since the 10 January 2013, more than double the \$14.47/MWh recognised by ACIL Tasman in the FY2013 Determination.

These specific pricing outcomes are largely the result of constraints on intra-regional transmission lines (855 Calvale–Stanwell and 871 Calvale-Wurdong) – this situation is well documented by the AER and others, and does not warrant further discussion here except to observe that there are many conditions which can lead to price volatility, not just organic demand growth. This specific matter was raised by Origin last year as a material deficiency in ACIL Tasman's pool price modelling:

“Finally, Origin would highlight that by omitting transmission constraints, ACIL's modelling is always likely to underestimate the real cost of energy in Queensland.

Transmission constraints are a significant driver of pool price volatility in Queensland with the recent Calvale-Wurdong transmission constraint during the first quarter of 2012 adding over \$4/MWh to the quarterly pool price. This is a significant omission but is probably not a priority given the many other issues with ACIL’s modelling approach and current unrealistic outcomes.”



There are a number of important features of this current price volatility which highlight deficiencies in ACIL Tasman’s proposed tariff methodology:

- The ability of spot prices and Futures market prices to rise materially from their lows, as highlighted in Origin’s recent submission to the Cost Consultation paper.
- Price events often come swiftly and without warning, with no gentle transition to the new pricing level or a signal it is coming; conversely ACIL Tasman has advised the QCA that any material increase in market prices is unlikely in the next 3-5 years.
- The price increases observed are not related to predictable load patterns, nor reflect a meaningful change in the supply/demand balance, but have arisen from a technical opportunity for the supply side to bid in a way that achieves these prices. Consequently these price events cannot be responded to in the short term as they do not reflect a logical signal that the market can prepare for (eg. price is not following demand for electricity).
- These price events reflect the fact that wholesale prices in Queensland have been unsustainably low in recent years. The supply side will continue to apply upward pressure to wholesale prices to maintain the economic viability their businesses. This current example, along with recent mothballing of NEM generation capacity, are rational supply side responses which will continue until prices achieve a fair long term economic return.

Risks for Retailers

Notably this particular example does not alter the FY2013 tariff as it has already been set. The FY2013 tariff was set based on the median of ACIL Tasman's Market Based scenarios, while recent spot price events materially exceed their Q1 median scenario. While the market expects these price events to occur, at the time the market had considered it unlikely for FY2013 and therefore were not reflected in the Futures prices used by ACIL Tasman to set the FY2013 tariff. While not directly addressing the issue of subsequent movement in Futures prices post May when the tariff is determined, Origin support ACIL Tasman's proposal to adopt at least a 95th percentile scenario for their Market Based methodology, and strongly suggest the 99th percentile recognising the materiality of events in the tail of the distribution.

ACIL Tasman's methodology implies a retailer will have completed all hedging for the coming financial year by the preceding May, yet Futures trading volumes indicate that this is not the case in practice. To the extent a retailer does not follow this theoretical hedging strategy in structure or timing, there are material risks which are not accommodated within the proposed tariff. This mismatch between wholesale market dynamics and retail tariffs weakens the viability of Retailers as they remain exposed to these wholesale market movements which the tariff does not reflect. As these price events occur in order to achieve a fair long run average wholesale price; retailers bear the material risk that increases in the wholesale market price are not reflected in the retail tariff. The absence of an adequate risk premium to accommodate Futures price changes post May, increases the likelihood of Retailer of Last Resort events for an exposed retailer (either exposed to spot prices, or quite reasonably still purchasing Futures contracts throughout the year).

Risks for Customers

In this particular example the FY2014 Futures contracts have been largely unaffected as the intra-regional constraints underlying these prices are expected to be built out by early 2014. However there are many ways in which price volatility can occur and evidence of the supply side willingness to use them.

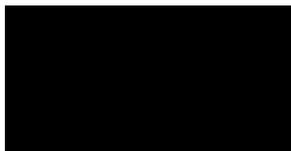
In the event that future price shocks do flow into Futures prices such that they affect tariff determinations by the QCA, these risks rest with the consumer via the tariff. Given the need for the supply side to achieve sustainable price levels; the fact the Futures and spot markets have been priced at cyclical lows in recent years; and that movements from these levels have been evidenced to be very strong and volatile when they do occur, the retail tariff could exhibit significant volatility in the foreseeable future; contrary to the advice of ACIL Tasman.

The National Electricity Objective, as enshrined in the National Electricity Law is to *“promote efficient investment in, and efficient operation and use of electricity services for the long term interests of consumers ... with respect to price, quality, safety, reliability and security of supply”*. If the tariff dynamics are distorted by regulatory assumptions that are removed from the actual market risks, the incentives for investment and innovation to deliver consumer benefits are at significant risk, thereby threatening the financial viability of the industry. Further, the volatility of retail tariffs from their linkage to Futures market pricing is at odds with the provision of stable and predictable pricing outcomes for customers, and inconsistent

with the National Electricity Objective designed to deliver long-term energy reliability and security.

Please contact me on (02) 9503 5114 or phil.moody@originenergy.com.au should you have any queries.

Yours Sincerely,



Phil Moody
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