Submission to the Queensland Competition Authority on the Consultation Paper: Regulated Retail Electricity Prices 2013-14

January 2013

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Executive Summary

In its Consultation Paper, the Queensland Competition Authority (QCA) states that the two key factors it must consider in making its price determination are:

- cost reflectivity; and
- the impact on competition.

These two factors are contingent on each other – in order for there to be effective and sustainable competition to the benefit of consumers, costs (both short and long term costs) must be able to be recovered. While there are positive features introduced in the proposed methodology, there remain two material deficiencies that will prevent true cost reflectivity being achieved:

(i) the wholesale energy cost allowance is not reflective of the actual costs of supplying retail customers; and

(ii) the determination does not accommodate material forecast errors in (and therefore cost impacts of) schemes such as the SRES.

Origin's position remains that Power Purchase Agreements (PPAs) and internal generation (a natural hedge, equivalent to a PPA) constitute real and material energy costs, the recovery of which must be enabled – either explicitly or by proxy. While explicit recognition of costs would be preferred, the QCA has chosen to disregard confidential information regarding these costs provided by Origin and others on the grounds that they are not readily observable through publicly available data.

The QCA has decided to adopt a market based approach to assessing wholesale energy costs, which must therefore by proxy be structured in a way that the real and legitimate costs of wholesale energy supply are able to be recovered. Origin's comments in this submission focus on how this can be achieved.

Comments for highlighting in this executive summary are those relating to the calculation of wholesale energy costs, and to the calculation of retail margin with respect to risk.

<u>Wholesale Energy Costs</u>

Any assessment of wholesale energy costs must be cognisant of the size of the load to be hedged. Price and volume are intrinsically related and cannot be assessed in isolation. As part of the market based approach proposed, the model hedge portfolio constructed for retailers by ACILTasman (ACIL) only references the price of Futures contracts. The volumes traded through the Futures market, at present, are insufficient to hedge all of Queensland small customer retail load and therefore these observed prices cannot be used in their current form to infer a market based cost for small retail customers:

- The volume of the Futures market contracts traded relative to retail load demonstrates clearly that Queensland retailers are hedging substantially with other arrangements outside of the Futures market.

- The incremental nature of the Futures market suggests that if the volume of trade increased so that all retail load was hedged with Futures, the price would increase.

As the current Futures price does not represent the market cost of wholesale electricity for an efficient retailer Origin requests that the QCA either:

1. Calculate market based costs by reference to the prices within a portfolio of different hedging instruments (short term and long term) consistent with the instruments ACIL has itself identified as being used by retailers to hedge risk; or

2. If calculating market costs exclusively by reference to Futures prices, adjust this price to recognise that Futures contract prices would be significantly higher if retailers were to meet all of their hedging requirements using Futures.

In rejecting the application of prices of PPAs ACIL argues that "by their nature these prices or implied prices are long term averages and do not necessarily represent the costs that would be expected to be incurred in any particular year – on some occasions they would likely be well above the expected costs and in other years well below"[1]. While Origin agrees that PPA prices are long term averages, the PPA price is the cost that will be incurred by a retailer that is party to a PPA during a given year. The price will, as ACIL notes, vary from the spot or Futures price for that year, nonetheless it represents the actual cost of supplying electricity for the retailer.

ACIL has also identified challenges in developing a model portfolio of different hedging instruments, however Origin believes these issues can be overcome. Indeed ACIL has dealt with this issue under previous methodologies by using an LRMC approach to derive a view of the cost of generation and PPAs. While ACIL does not have access to all individual retailers' hedging strategies, the combination of confidential information already provided by retailers and public data should allow ACIL to develop a reasonable view of the hedging practice of the market as a whole. A price for ACIL's model contract portfolio could then better be derived as a weighted average of Futures prices and the price of long term hedging instruments.

Origin does not accept ACIL's assertion at the QCA's recent workshop (19 December 2012) that contract information that is confidential or concerns a related party transaction should not be considered by the QCA. ACIL is well placed to benchmark confidential information against public data. The appropriate test should be whether or not the contract is likely to be an efficient arrangement.

Retail Margin

While Origin agrees that IPART's 5.4% retail margin can be used as a base, the margin will need to be increased to compensate for a number of critical differences between the QCA's and IPART's pricing frameworks:

- The NSW regulatory framework has substantially less risk than the Queensland framework as for a three year period it applies a floor price to the wholesale energy cost which incorporates a weighting of 75% LRMC and 25% market based approach. Queensland retail margin will need to be higher than NSW to compensate for this risk.

- The NSW determination effectively incorporates a cost pass-through mechanism to account for uncertainties; for example, SRES cost variations. This risk management mechanism mitigated the need for a higher retail margin. With a three year Terms of Reference the QCA should adopt a similar approach. Queensland retail margin will need to be higher than NSW to compensate for this risk.

- The NSW determination applies final network tariffs. In Queensland the Final Decision is likely to be made before network tariffs are finalised, exposing retailers to any network tariff variation. Queensland retail margin will need to be higher than NSW to compensate for this risk.

To the extent that the identified issues are not individually, specifically and fully addressed by changes to the proposed methodology, then non-systematic risk is created, and must be accommodated in the retail margin.

[1] Page 6, Estimated energy costs for use in 2013-14 electricity retail tariffs, ACIL Tasman, Dec 2012

1. Introduction

On 5 September 2012, the Minister for Energy and Water Supply delegated to the QCA the task of determining regulated retail tariffs for a three year period from 1 July 2013 to 30 June 2016. Under the Delegation, the QCA must set notified prices on an annual basis for each year in the three year period, with the first determination to apply from 1 July 2013 (the 2013-14 Price Determination). The Terms of Reference require that the N (network) + R (retail) cost build-up approach be used to determine the tariffs.

In accordance with section 90(5)(a) of the *Electricity Act 1994*, the QCA must have regard to the following in making its price determination:

a) the actual costs of making, producing or supplying the goods or services;
b) the effect of the price determination on competition in the Queensland retail electricity market;
c) any other matter required under the Delegation; and
d) any other matter that the QCA considers relevant.

The Terms of Reference require the QCA to consider a number of specific matters, including:

a) basing each annual price determination on a N + R cost build-up approach;
b) the Queensland Government's Uniform Tariff Policy (UTP);
c) basing the network cost component for:
    i. small customers on the network charges to be levied by Energex; and
    ii. large customers on the network charges to be levied by Ergon Energy.
d) transitional arrangements for the standard residential tariff (Tariff 11), the existing obsolete tariffs and customers on the large customer business tariff introduced in 2012-13.

On 21 September 2012, the QCA released an Interim Consultation Paper advising stakeholders of the commencement of the review and seeking submissions. On 2 November 2012, the QCA released a consultation paper in relation to the transitional issues that it is required to consider as part of this review.

The QCA has now released a Consultation Paper which identifies the key issues on which the QCA particularly seeks comments from interested parties. The QCA has noted that stakeholders should take this opportunity to inform the QCA of any other matters they believe are relevant. The QCA has engaged ACIL Tasman (ACIL) to provide expert advice on estimating energy costs. ACIL has prepared some preliminary analysis of energy costs (Estimated Energy Costs for Use in 2013-14 Electricity Retail Tariffs) (ACIL Report) which has been released by QCA to accompany the Consultation Paper.

The QCA held a workshop on 19 December 2012 to provide initial discussions on the matters raised in the Consultation Paper, the ACIL Report and the earlier consultation paper on transitional issues.

The QCA has identified the two key factors to consider when making its price determination to be:

1. Cost reflectivity; and
2. The impact on competition.

The QCA must also consider whether and how to implement a transitional path to cost-reflective notified prices for certain customer groups (to be considered in detail in a separate consultation paper).

The QCA has noted that competition has developed considerably in the Queensland retail market since it was introduced more than five years ago, and considers that, while having regard to costs is important in setting notified prices, a key aim is to provide a transition to effective competition and eventual price deregulation, particularly in SEQ.

2. Energy Costs

2.1 Introduction

In determining the energy costs faced by retailers, section 90(5) of the *Electricity Act 1994* requires the QCA to have regard to:

a) the actual costs in making, producing or supplying the goods or services;
b) the effect of the price determination on competition in the Queensland retail electricity market;
c) any other matter required under the Delegation; and
d) any other matter that the QCA considers relevant.

The QCA has stated in the Consultation Paper that, while it is generally satisfied with the framework it adopted to determine energy costs in its 2012-13 Determination, it is open to suggestions from stakeholders on how that framework might be improved or why an alternative approach might be appropriate for the 2013-14 review. In particular, the QCA has noted that it is required under the Delegation to consider whether its approach can strengthen or enhance the underlying network price signals and encourage customers to switch to time-of-use tariffs and reduce their energy consumption during peak time.

2.2 Judicial Review

Origin's application for judicial review of the cost of energy approach used by the QCA in making its 2012-13 Regulated Retail Price Determination was dismissed by the Queensland Supreme Court on 19 December 2012.

The case did not consider or test the merits of the market based methodology or its impact on competition. The decision does not mean that the QCA is not able to take PPAs into account; the QCA may do so if it considers them to be relevant to the cost of purchasing energy.

Origin submits, as elaborated below, that longer term hedge contracts, such as PPAs and internal generation (a natural hedge, equivalent to a PPA), are an integral component of many retailers actual cost of supplying energy and is critical to achieving cost reflectivity and effective competition.

2.3 Wholesale energy costs

2.3.1 Origin's position on methodology

The QCA has sought stakeholders' views on whether ACIL's proposed method for estimating wholesale energy costs is reasonable given the requirements of the Electricity Act and the Delegation, and what other approaches should be considered.

Origin's position remains that PPAs and internal generation constitute material and legitimate elements of the wholesale energy market and must be taken into account in assessing wholesale energy costs. Origin and others have furnished the QCA with confidential information regarding these costs however to date the QCA have disregarded them on the grounds that they are not readily observable through publicly available data. While this should not be a constraint to the QCA as it has powers to acquire such data if it chooses, Origin maintains that these costs can be tested against publicly available data with reference to an assessment of "stand alone" LRMC.

Origin does not accept ACIL's assertion at the QCA's recent workshop (19 December 2012) that contract information that is confidential or concerns a related party transaction should not be considered by the QCA. Other jurisdictions have successfully relied on a combination of public and confidential information. IPART's regulation of the NSW gas market is largely based on an assessment of retailers' confidential gas cost information. The appropriate test should be whether or not the contract is likely to be an efficient arrangement.

ACIL is well placed to verify Origin and other retailers' confidential cost data as ACIL already holds similar information that it applies as inputs to its pool forecasting model for the QCA and also for LRMC modelling in other circumstances. The calculation of a benchmark PPA price is a much simpler task than modelling spot price scenarios in the NEM. AGL's supplementary submission of 8 May 2012 sets out two methods with worked examples to estimate PPA costs using data previously published by ACIL, which can be used to assess the confidential data. ACIL should therefore be capable of assessing confidential and related party cost information. If there is evidence that these costs are inefficient these costs should be adjusted accordingly. It is not sufficient to dismiss the data because it relates to a confidential transaction or involves ownership of generation assets.

2.3.2 LRMC

Origin's response to the QCA's Interim Consultation Paper sets out in detail its views on the relative advantages of the "stand alone" LRMC approach and problems posed by adopting a market based approach. Origin contends that the wholesale methodology should take account of long term hedging instruments, including PPAs and the natural hedge delivered by owning generation. These costs can be estimated by applying an LRMC methodology.

A "stand alone" LRMC based methodology is a more appropriate and accurate means of estimating the wholesale energy cost than a Futures market based approach because:

- it is a forward looking approach that better approximates the actual costs of retailers' purchases through PPAs and of internal generation;
- it is linked to the NEM (as generation investment, along with other factors, influences the prices in the spot and contract market), but it is not wholly dependent on market conditions at a point in time;
- it is an estimate for average wholesale energy costs that has theoretical merit as well as being readily modeled and identifiable; and
- it is far less volatile over time than a market based approach.

We note that ACIL's reference to LRMC in its methodology paper refers to an "incremental" approach and is inconsistent with ACIL's recent advice to ESCOSA[2]:

> "A standalone or greenfield approach, which assumes that there is currently no generation plant to serve the required load. The approach theoretically builds, and prices, a whole new generation system that is least- cost. In effect, it re-prices all existing capacity at efficient levels and includes the capital costs of new plant in the LRMC estimate.
>
> An incremental approach, which assumes that the existing mix of generation plant in the system is in place and that the required load can be served using both existing generation plant and new generation plant. This approach prices loads on the basis of the least-cost way of adding to the existing stock of plant and does not factor in the capital costs of existing plant as this is assumed to be sunk.
>
> The standalone or greenfield approach is used for estimating the LRMC for the purposes of regulating retail prices. The incremental approach results in a very low LRMC (more related to the short run marginal cost) unless new generation is immediately required."

For the avoidance of doubt, any references by Origin to LRMC here relate to the "standalone" approach, consistent with ACIL's recommendation to ESCOSA above.

Origin understands from the recent QCA Workshop (Review of Regulated Retail Electricity Prices 2013-14, 19 December 2012), that the QCA has chosen to continue to apply the market based approach used in the 2012-13 price determination. The remainder of this submission therefore focuses on improvements that could be made to ACIL's proposed market based methodology.

2.3.3 ACIL's proposed methodology and consequences

ACIL's proposed market based approach for Queensland is set out in its consultation paper and can be summarised as:

1) Forecasting the wholesale electricity spot price by simulating the operation of the NEM using a wholesale energy market model.

2) Developing a model contract portfolio that a prudent and efficient retailer would use to hedge against demand and spot price risk in a given year.

3) Estimating forward contract prices.

4) Calculating the resulting energy cost by applying the model hedge portfolio to a retailers load under the forecast load/spot price scenarios.

ACIL has identified a range of hedging instruments used by retailers to manage price risk that include[3]:

- acquiring and using own generation;
- power purchase agreements (PPAs) or tolling agreements with third party generators;
- bilateral arrangements between retailers and generators;

[2] *(p5 s3.1; Approaches to setting the wholesale electricity cost allowance - Prepared for Essential Services Commission of South Australia 26 July 2012)*

[3] Page 5, Estimated energy costs for use in 2013-14 electricity retail tariffs, ACIL Tasman, Dec 2012

- broker arranged over the counter (OTC) contracts (may include a wide range of contract forms);
- exchange traded swap and cap contracts available in the Futures market.

However, of these five categories of hedge sources, ACIL has chosen to reference only the exchange traded Futures products when estimating forward market prices. This is an inappropriate definition of the "market" as it ignores the large majority of hedge sources. Origin and AGL are the largest retailers in Queensland, together accounting for nearly 60% of the small customer market[4]. These retailers have hedge portfolios that include PPAs and the natural hedge provided by internal generation, these supply costs must be included in a market based assessment of supply cost.

2.3.4 Increased customer price volatility

ACIL has previously stated that the Market Based approach yields the same outcome as the LRMC in the long run.[5]

> "In a competitive market, the price outcomes will align with the LRMC over the long-term. If the price outcomes were lower than the LRMC over the long term, generators would not be viable. If the market is competitive then the price outcomes will not be higher than the LRMC values over the long term. As the price outcomes align with the LRMC over the long term, the LRMC has been used by some regulators in determining the energy cost component of the retail electricity price."

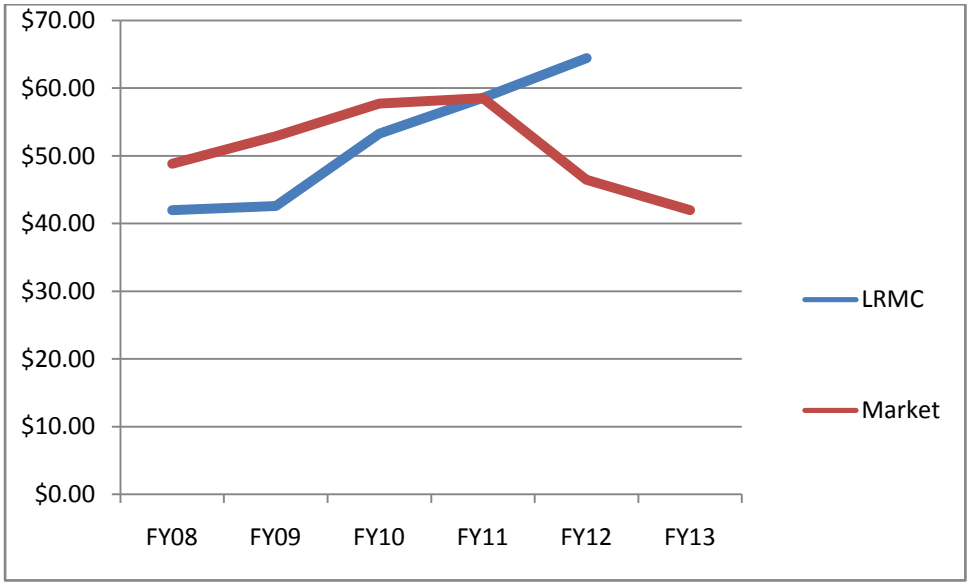
Recent history demonstrates that there is significant year on year variability in a market based assessment of energy cost. Origin considers that a methodology that delivers this level of variability in customer tariffs is not appropriate. It also does not reflect the lower variability in retailers actual supply costs. It would not be efficient or prudent for a retailer to rely entirely on Futures contracts or to accept the associated variability in their energy supply costs. Origin has entered into long term hedge instruments (PPAs and ownership of generation that delivers a natural hedge) to reduce this level of variability. As ACIL has noted other retailers adopt a similar approach. The QCA's methodology should take account of long term hedge instruments to reduce volatility in customer tariffs over time.

As Chart 1 below illustrates, the difference in energy cost likely to be estimated between using ACIL's market based methodology and standalone LRMC is material, at least $20/MWh. By definition, if LRMC and market based outcomes are equal over time, one should expect a $40/MWh turn around in the market based price within this market cycle. Based on the current tariff, this movement reflects at least a 20% increase in the consumer tariff when it occurs, all other things being equal. If the market based price has not yet reached the bottom of the cycle then this increase will be even more.

[4] P. 121. Figure 5.1, State of the Energy Market 2012, AER.
http://www.aer.gov.au/sites/default/files/State%20of%20the%20energy%20market%202012%20-%20Chapter%205%20Energy%20retail%20markets%20%28A4%29.pdf

[5] Page 5; Approaches to setting the wholesale electricity cost allowance - Prepared for Essential Services Commission of South Australia 26 July 2012, ACIL Tasman)

Chart 1. ACIL Tasman's Comparison of LRMC and market based estimates for Queensland energy cost ($/MWh, nominal)



Source: Page 9 s3.4.1; Approaches to setting the wholesale electricity cost allowance - Prepared for Essential Services Commission of South Australia 26 July 2012.

In practice the behaviour of electricity market cycles is less symmetrical, with extended periods below LRMC, but much higher excursions above LRMC (for shorter periods) when they do occur. This means that the 20% price shock is likely to be much more than this when the market does tighten.

Notwithstanding ACIL's assessment (discussed in Section 3.3.4 below), it is possible for the market to tighten sooner through supply side responses such as mothballing existing generation stock. The supply side has already demonstrated a willingness to do this; also confirming that current wholesale prices are unsustainably low. During 2012 over 2000MW of generation capacity has been mothballed or permanently shut down in the NEM. Plants completely or partially shut down include Tarong (Qld), Swanbank B (QLD), Mackay Gas Turbine (Qld), Munmorah (NSW), Northern (SA) and Yallourn (Vic). A further reduction in available capacity is likely to lead to earlier increases in prices. While mothballed plant can be returned to service it is clear that owners of this plant will not return it to service unless it is economic to do so, and evidently not at current market price levels.

The customer price volatility inherent in ACIL's market based approach could be reduced by expanding the definition of Market to reflect the portfolio of hedge sources ACIL have acknowledged constitute those used by retailers, rather than just the price of Futures contracts. This solution is discussed further in Section 2.3.6.

2.3.5 Increased risk for retailers

In theory under the market based approach retailers with long term supply arrangements will benefit from higher regulated tariffs when wholesale prices rise. However those retailers that have entered into efficient long term supply arrangements face the risk that the regulated pricing methodology changes when wholesale prices rise. There are no examples in Australia where a jurisdiction has maintained a wholesale pricing methodology for a period long enough to cover a full market cycle (i.e. where either LRMC or a market based methodology applies consistently over time). While the QCA has verbally committed

to maintain the market based approach for the 2013-16 period[6], there is no certainty of a consistent methodology beyond this point nor capacity for the QCA to do so.

The normal market cycle has been exacerbated by the broader economic slowdown and the strong Australian dollar resulting in unprecedented softening of domestic demand for electricity. As a result of these circumstances, ACIL assesses that this cycle will not tighten within the next 3-5 years[7] meaning the period of commitment to this methodology will need to be well beyond 5 years on this basis. This view is consistent with current spot prices and AEMO's supply and demand projections.[8] There is therefore a mismatch between the three year period of the current terms of reference and the duration of wholesale market cycles.

As the recent imposition of a tariff freeze (and subsequent consideration of a gradual transition back to cost reflectivity) for Tariff 11 demonstrates, Governments are reluctant to allow rapid rises in retail tariffs. Such a price rise may be required to reflect wholesale market prices when the supply demand balance next tightens.

Retailers therefore face the significant risk that subsequent determinations will not allow the market based methodology in its current form to pass through materially higher wholesale energy costs to customers when they arise.

Origin proposes that this risk is reduced by assessing the market based wholesale energy cost of a portfolio of hedge sources, rather than just the price of Futures contracts recognising the pricing of longer term products and hence reducing the level of volatility in the market based outcome. This solution is discussed further in Section 2.3.6. In the absence of such an approach this non-systematic risk must be accommodated for in the retail margin (see Section 3.2).

2.3.6 Futures Volume problem and proposed solution

Any assessment of wholesale energy costs must be cognisant of the size of the load to be hedged. Price and volume are intrinsically related and one cannot be assessed in isolation.

The task at hand is to determine the wholesale energy cost allowance for small customers – including today's non-market customers and those that may return at anytime as small customers have the right to return to the notified price. This has occurred in other jurisdictions when the regulated tariff has been set inappropriately low, such as NSW in 2007/08 when a substantial number of customers returned to regulated tariffs.

The volumes traded through the Futures market, at present, are insufficient to hedge all of Queensland small customer retail load and therefore these observed prices cannot be used in their current form to infer a market based cost for small retail customers.

An assessment of energy purchase costs that is based solely on Futures prices therefore cannot be representative of retailers' hedge portfolios either in terms of volume or price:

- The volume of the Futures market contracts relative to retail load suggests that Queensland retailers are hedging substantially with other arrangements outside of the Futures market. Trade volumes to date are provided in Chart 2 and detailed in Section 2.3.7.

[6] QCA advice at the QCA workshop, 19 December 2012.
[7] *Page 12 s4;* Estimated energy costs for use in 2013-14 electricity retail tariffs, ACIL Tasman, Dec 2012

[8] AEMO, 2012 Electricity Statement of Opportunities for the National Electricity Market, p 3-2, figure 3-1

- The incremental nature of the Futures market suggests that if the volume of trade increased so that all retail load was hedged with Futures, the price would increase. An increase in price is to be expected as the ability of generators to continue to offer additional Futures hedge volume is limited by their existing long term contractual commitments and general practice of not hedging their last generation unit to manage outage risk (an N-1 approach).

It should also be noted that less than half of the total Futures contract volume traded is likely to have been purchased by Retailers to hedge their mass market load. The balance will have been purchased by retailers to hedge sales to C&I customers or as transactions between intermediaries that do not deliver a hedge to retailers.

As the current Futures price does not represent the market cost of wholesale electricity for an efficient retailer Origin proposes that the QCA either:

1. Calculate market based costs by reference to the prices within a portfolio of different hedging instruments (short term and long term) consistent with the instruments ACIL has identified as being used by retailers to hedge risk; or

2. If calculating market costs exclusively by reference to Futures prices, adjust this price to recognise that Futures contract prices would be higher if retailers were to meet all of their hedging requirements using Futures.

ACIL has identified challenges in developing a model portfolio of different hedging instruments; however Origin believes these issues can be overcome. While ACIL does not have access to all individual retailers' hedging strategies, the combination of confidential information already provided by retailers and public data should allow ACIL to develop a reasonable view of the hedging practice of the market as a whole. A price for ACIL's model contract portfolio could then better be derived as a weighted average of Futures prices and the price of long term hedging instruments.

In rejecting the application of prices of PPAs, ACIL argues that "by their nature these prices or implied prices are long term averages and do not necessarily represent the costs that would be expected to be incurred in any particular year – on some occasions they would likely be well above the expected costs and in other years well below".[9]

While Origin agrees that PPA prices are long term averages, the PPA price is the cost that will be incurred by a retailer that is party to a PPA during a given year. The price will, as ACIL notes, vary from the spot or Futures price for that year, nonetheless it represents the actual cost of supplying electricity for the retailer. Unless the PPA can be demonstrated to be an inefficient arrangement then its cost should be considered by the QCA.

Origin has previously provided the QCA with confidential information regarding the volumes and costs of its own generation and PPAs.[10] Origin understands that other retailers have also provided confidential details of their long term supply arrangements.

As noted in Section 2.3.1 ACIL is well placed to verify Origin and other retailers' confidential price data by applying one of the approaches described in AGL's supplementary submission, dated 8 May 2012.

[9]Page 6, Estimated energy costs for use in 2013-14 electricity retail tariffs, ACIL Tasman, Dec 2012
[10]Confidential Supplementary Submission on QCA Draft Determination: Regulated Retail Electricity prices 2012-2013 (Draft Determination),11 May 2012

2.3.7 Liquidity problem and proposed solution

ACIL presented preliminary analysis of Futures prices at the QCA workshop on 19 December 2012. The Futures prices ACIL derived are noted in Table 1 below.

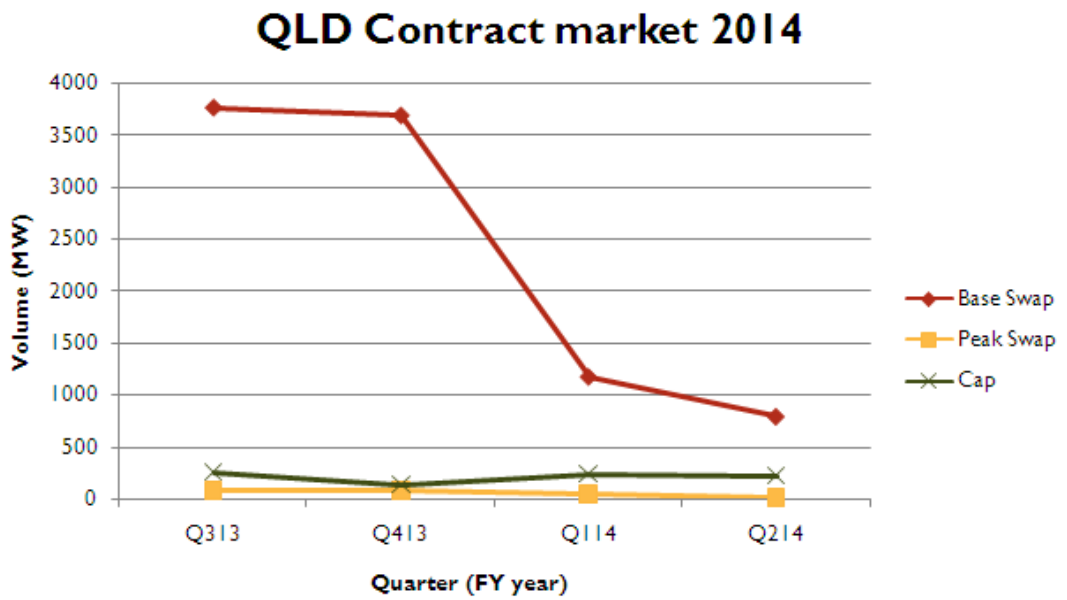
Table 1. Preliminary Contract Price Estimates, ACIL Tasman 19 Dec 2012.

Year	Quarter	Average costs of d- cypha contracts in 2013-14 ($/MWh)		
		Base	Peak	Cap
2014	Q1	$66.33	$87.75	$14.34
2014	Q2	$53.15	$59.75	$2.74
2013	Q3	$53.35	$60.72	$3.49
2013	Q4	$54.77	$65.98	$7.47
Average for 2013-14		**$56.90**	**$68.55**	**$7.01**

Source: ACIL Tasman analysis of d-cypha contract data until 12 November 2012

Origin has reviewed recent D-Cypha published contract data from 1 October 2012 to 28 December. The volumes (MW) traded for each quarter by product (base swap, peak swap and cap) are plotted in Chart 2 below.

Chart 2. Volume of Futures Contracts Traded (MW) for each Quarter in FY14



Only a proportion of the Futures contracts shown will have been purchased by retailers to hedge their mass market load. The balance will have been purchased by retailers to hedge sales to C&I customers or as transactions between intermediaries that do not deliver a hedge to retailers. Nonetheless a comparison of the total traded volumes to date with the contract volumes ACIL assumed for its model contract portfolio for the FY2013 Determination[11] demonstrate that peak swap and cap trades lack sufficient liquidity to be a good proxy for a retailer's hedging costs:

- There has been a negligible volume of peak swap contracts traded in all quarters Q313 (75MW), Q413 (80MW), Q114 (40MW) and Q214(5MW). ACIL's model contract portfolio for the FY13 determination assumed up to 786MW of peak swaps were required.

- There has been between 140MW and 250MW of cap contracts traded in each quarter for FY14. ACIL's model contract portfolio for the FY13 determination assumed up to 1,266MW were required.

The liquidity for base swap contracts is better. Although even if it is assumed that all Futures contracts traded result in retail hedge volume for the mass market then the volume of base swap Futures contracts at around 21TWh is still well below ACIL's assumed model portfolio requirement for FY13 of around 27TWh.

Origin does not accept that using thinly traded data in isolation is a robust approach. Cross checking this data against AFMA prices is also of limited value, as the AFMA data lacks trading volumes.

Origin encourages the QCA to recognise that estimates for peak and cap prices in particular are likely to be based on very little trading data and therefore subject to a high degree of forecast error. The low volume of Futures transactions shows that the Futures market (particularly for peak products) is an incremental contract market that only covers a small

[11] Contract volume data file for 2012/13 determination at http://www.qca.org.au/files/ER-ACIL-NEP1213-ContractVol-0312.PDF

proportion of the actual electricity volumes supplied to Queensland's mass market customers.

Origin considers a more reliable approach would be to combine Futures data with the contract data provided on a confidential basis by retailers to derive an average price for a portfolio of short and long term instruments.

If Futures data is to be used in isolation there will need to be an escalation of forward contract prices or inclusion of a substantial additional risk premium in the retail margin to account for the problem of forecasting Futures prices in illiquid markets.

2.3.8 Demand Forecasts

Origin supports the use of the system demand forecast for FY13/14 published by the Australian Energy Market Operator in its Electricity Statement of Opportunities, 2012. This has the advantage, relative to Powerlink's forecasts, of providing consistent NEM wide data as an input to ACIL's Pool price forecast.

Origin suggest that ACIL extend its data set to include FY09 as this year contains a number of months in which the maximum demand was the highest of recent years. This will assist with establishing the correlation between temperature and demand used to create synthetic load profiles.

Origin reiterates the advice it provided in its 2012-13 submission[12] that historic NSLP data should be adjusted such that the load profile is based on the current Queensland NSLP minus non-residential customers consuming greater than 100MWh per annum.

ACIL propose addressing load variability by selecting the 95th percentile of the 462 simulated annual hedged prices to represent the energy cost in 2013-14. Origin's Board approved risk policy is to hedge for a 1 in 100 load event. ACIL's proposed approach to hedge for the 95th percentile creates a significant risk for retailers, given the asymmetry of price outcomes.

It is important that ACIL provide sufficient load and price data across the range of modeled demand scenarios to allow stakeholders to assess the variability of load and price captured by the modeling and the distribution of modeled outcomes.

2.3.9 Treatment of Carbon

It is not clear to Origin why a separate carbon price is to be calculated given the framework the QCA are using to set the FY14 tariff. ACIL's methodology yields a carbon inclusive price. We would expect that any material change to the carbon price mechanism such as the repeal of the Clean Energy Act would be subject to a specific assessment of the wholesale energy costs for this purpose should it occur and affect the FY14 period. To the extent that the carbon allowance being assessed at this stage is for the purpose of carbon bill message, then we consider this method to be appropriate for this purpose.

[12] **Submission to the Queensland Competition Authority on the Draft Determination: Regulated Retail Electricity Prices 2012-13, April 2012**

3. Retail Costs and Margin

3.1 Retail Operating Costs

The QCA considers that the benchmarks used for setting notified prices for 2012-13 are an appropriate starting point for setting notified prices for 2013-14.

Origin supports this benchmarking approach and that the benchmarks set for 2012-13 are an appropriate starting point for setting notified prices for 2013-14.

Origin notes that there may be differences between retail operating costs estimated by IPART before the 2010 determination and its estimates for FY 2013-16. These differences will reflect the different scope and size of the businesses and will be further complicated by differing cost allocation practices.

Origin supports the continued application of ROC to the fixed component of the tariff.

3.2 Retail Margin

As Origin has noted in its response to the QCA's Interim Consultation paper, Origin does not support adopting the IPART margin approach (5 per cent), without recognising the significant differences between the Queensland and NSW regulatory settings.

IPART's retail margin is only intended to provide for recovery of systematic risks on the basis that all non systematic risks are addressed in other elements of IPART's cost assessment. There are a number of critical differences under IPART's regulatory framework that the QCA will need to address:

- The NSW regulatory framework has substantially less risk than the Queensland framework as for a three year period it applies a floor price to the wholesale energy cost which incorporates a weighting of 75% LRMC and 25% market based approach.

  By comparison under ACIL's proposed approach (that excludes the costs of long term hedges) retailers with long term supply contracts would be subject to considerable political/regulatory risk (see Section 2.3.5).

- The NSW determination incorporates a cost pass-through mechanism to account for uncertainties; for example, SRES cost variations. This risk management mechanism mitigated the need for a higher retail margin.

- The NSW determination applies final network tariffs. In Queensland the Final Decision is likely to be made before network tariffs are finalised, exposing retailers to any network tariff variation

The margin component of QCA's regulated tariffs should account for these non-systematic risks.

Origin has set out a suggested mechanism to reduce the risk of uncertain events in Section 5 and also advocates a reduction in retailers' exposure to price volatility and mitigation of regulatory risk by including an assessment of long term hedge contracts in the wholesale energy cost (Section 2.3.6). However, should long term hedge contracts continue to be

excluded from the wholesale energy cost allowance then these risks must be accommodated in the retail margin.

Origin supports the continued application of the margin equally to the fixed and variable components of the tariff.

4. Retail Competition

The terms of reference require that QCA has regard to the effect of regulated retail prices upon competition. Retail tariffs should therefore be set at a level that is sufficient to protect and promote competitive market offers.

Regulated retail prices have a critical impact on the level of competition in Queensland.

Origin maintains that there has been a discernable reduction in competition as a result of the QCA's 2012-13 tariff decision. This is evident in terms of:

1. Level of marketing activity undertaken
2. The level of price discounts offered in the market
3. The level of churn (as a consequence of 1-2 above)

Level of Marketing Activity

Since the change in tariff Origin has observed a reduction in the level of marketing activity from electricity retailers. Since the 2012-13 tariff determination Origin has reduced its Queensland market offer discounts and greatly reduced its media spend in Queensland. Origin notes a similar change from other retailers:

- AGL has advised that "the material effect of the QCA's decision on retail margins has resulted in AGL substantially reducing its marketing activities in Queensland, including the removal of all door knockers and the cutting of discounts available to customers."[13]
- QEnergy has also stated that it has withdrawn from active marketing in Queensland.

Chart 4 below shows Origin's customer losses each month to competing retailers. As the chart indicates Origin's losses in Queensland have dropped by around 17% for the past six months compared with the same period last year. Two retailers (shown as Retailers 4 & 5) have significantly reduced their activity. Origin's losses are now largely accounted for by only three retailers. This is in contrast with Victoria where, as Chart 5 shows there are many more active retailers; most of Origin's customer losses in Victoria are spread across seven retailers.

EnergyAustralia's submission to the QCA's Interim Consultation paper presented a similar view. EnergyAustralia's losses were largely to one retailer, with few losses to other retailers. EnergyAustralia noted that this was in contrast to the activity levels before mid 2011 when losses were more evenly distributed across the retailers, indicating activity from a greater number of competitors.

[13] 2013 Earnings Guidance, AGL, 23 October 2012,

atHtttp://www.agl.com.au/about/ASXandMedia/Pages/2013EarningsGuidance.aspx

Chart 3. Origin Energy Queensland Electricity Customer Losses to Competitors

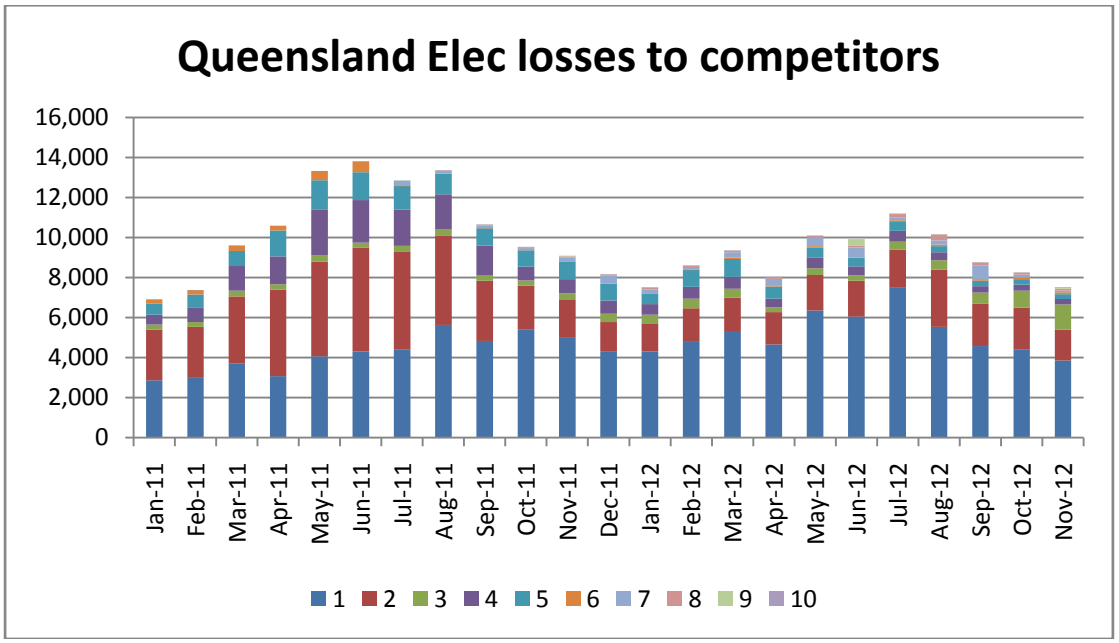
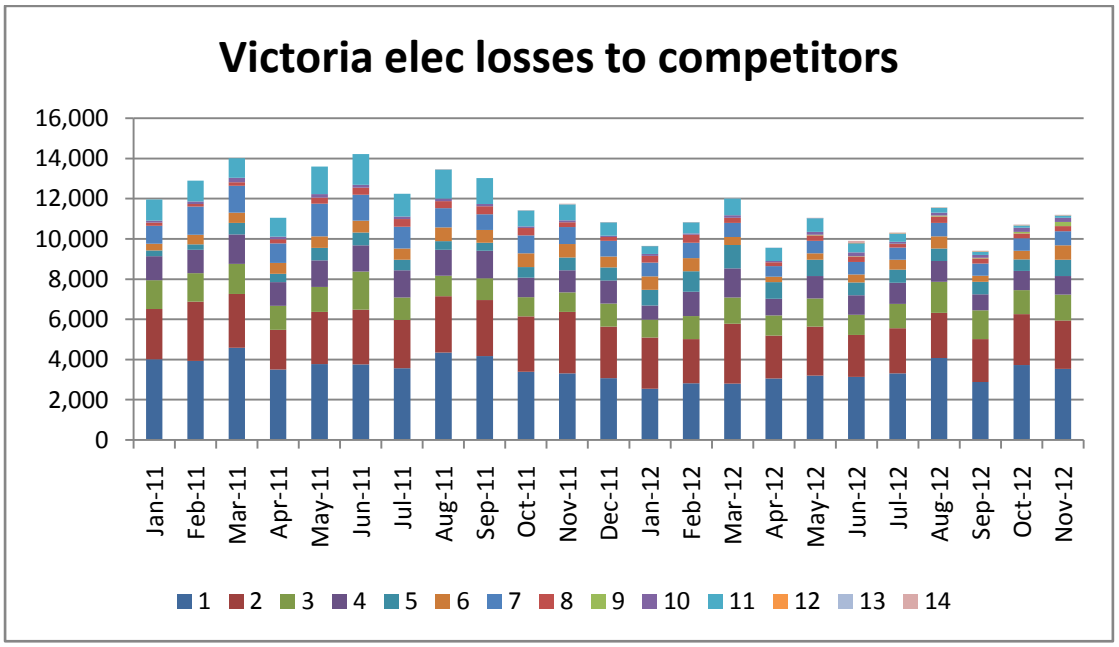


Chart 4. Origin Energy Victoria Electricity Customer Losses to Competitors



Level of Price Discounts in the Market

An indication of the level of competition in Queensland is provided by comparing retailers' market offers for electricity in Queensland with those in other states. Table 2 below shows the current retailer offers provided through the online energy comparison service iSelect.com.au

As Table 2 below illustrates the discounts offered by all retailers through iSelect in Queensland are substantially below those offered in all other states.

Table 2. Comparison of market offers made through iSelect.com.au

iselect (Elec)	Number of Retailers	Retailers	Current Market Offers
VIC	**8**	Origin	10% off usage +$100, 1yr
		AGL	13%+ 4%(POT) off usage, 2yrs
		Alinta Energy	15% off usage w/o contract
		Dodo	10% off usage w/o contract or 20% off usage, 1yr
		Energy Australia	3%+13%(POT) off bill, 3yrs
		Momentumn	Smile Power - Low rate deal (12, 24, 36 months)
		Power Direct	30% off usage, 3 yrs
		Red Energy	5% off bill w/o contract or 10% off bill 1 year contract
NSW	**6**	Origin	11% off usage +$175, 1yr
		AGL	10%+4%(POT) off usage, 2yr
		Dodo	7.5% off usage w/o contract or 15% off usage, 1yr
		Energy Australia	3%+9%(POT) off bill, 3yrs
		Momentumn	Smile Power (12, 24, 36 months)
		Red Energy	no discount
QLD	**4**	Origin	6% off usage, 1 yr
		AGL	3%+4%(POT) off usage, 2yr **or** $30 rebate w/o contract
		Dodo	5% off usage w/o contract or 10% off usage, 1yr
		Energy Australia	3%+7%(POT) off bill, 3yrs 3% off usage w/o contract
SA	**6**	Origin	12% off usage+$50, 1yr
		AGL	7%+3%(POT) off usage, 2yr **or** $60 rebate w/o contract
		Alinta Energy	15% off usage w/o contract
		Energy Australia	4%+10%(POT) off bill, 3yrs 3% off usage w/o contract
		Momentumn	Smile Power (12, 24, 36 months)
		Red Energy	10% off bill, 2yrs

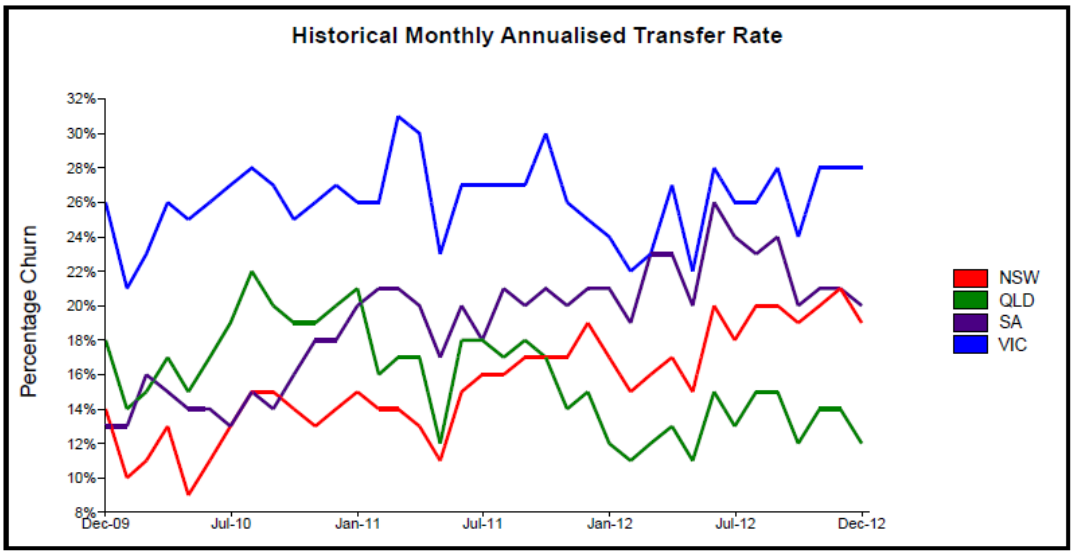
NB POT is the additional discount provided to customers that pay their bill on time.

The major retailers have reduced their on line offers from around 12% to 6% since the 2012-13 determination. AGL reduced their online offers around the end of August 2012 and both EnergyAustralia and Origin reduced their offers in November.

Level of Churn

Changes in the rate of customer switching in Queensland illustrate the impact that adverse regulatory outcomes can have on the development of effective retail competition. The chart below notes the impact of retail pricing decisions on competition.

Chart 5. Queensland Electricity Market Churn, (Annualised Percentage Churn)



Source: AEMO Market Transfer Information. Available at http://www.aemo.com.au/Electricity/Data/Metering/Retail-Transfer-Statistical-Data

As Chart 5 illustrates churn follows a somewhat cyclical pattern with higher levels of churn observed in Jun-Jul than in Dec-Jan. A comparison of Queensland's churn level (shown by the green line) before and after the announcement of QCA's change in approach in mid 2011 shows a much lower level of churn post change than before. Churn has declined across this period by around 3-5 percentage points year on year.

The chart shows that churn did not immediately decline on the QCA's announcement. This is to be expected as:

- There is a lead time for customer transfer after the sale due to the cooling off period and meter reading cycle
- Existing commitments with sales channels would extend activity as would the time to change collateral

Similarly, in NSW the impact of regulatory decisions upon competition is evident. The 2010 NSW determination based on LRMC reinvigorated competition in NSW with churn moving up from around 11% in 2009 to currently around 20% pa.

The QCA has observed that:

> *"While retailers pointed out that switching rates in Queensland dropped from July 2012 to September 2012, the Authority notes that this was also the case in other jurisdictions, which may mean that other factors not specific to Queensland were at play…"*

As is evident from Chart 5, Queensland exhibited a switching rate that was higher than or comparable to NSW until FY11 and in FY12 switching has been significantly below this level.

In Origin's view customer transfers has changed in other jurisdictions in response to specific circumstances.

- In Queensland, as noted above churn has decreased since the QCA announced its change in methodology.
- In South Australia the decision to adopt pricing of wholesale energy costs that do not take into account the full cost of wholesale energy has accompanied a fall in market churn.
- In NSW churn has remained stable but there has been no major change in the approach to setting retail prices.

Headroom Allowance

The inclusion of headroom is consistent with the objective and a headroom allowance represents a reasonable trade-off between the long term interests of customers, interests of retailers seeking to enter the market and the short term interests of consumers that choose not to take up alternative market offers.

In considering an appropriate level of headroom Origin proposes that QCA considers the level of discount against a regulated tariff a competing retailer may offer to attract customers and the full acquisition cost incurred over the expected "life" of the customer.

The QCA previously estimated a 6% headroom for residential customers (although allowed for only 5%). Given the decline in the level of competition, the QCA needs to adopt a headroom allowance at the upper end of the range.

The headroom allowance, like the retail margin should be expressed as a percentage margin on total costs.

5. Accounting for Unforseen or Uncertain Events

Origin reiterates its view that the three year Terms of Reference gives the QCA additional flexibility to deal with under and over-recoveries in one year in the next year to allow better cost-reflectivity; rather than being confined to a rigid review of costs only in the relevant year.

Origin has detailed in its response to the QCA's Interim consultation paper, alternative possible means of addressing regulatory and tax risk. These can be summarised as:

1. Adopting a forecast/catch-up mechanism. Under this approach the determination should include an allowance to account for future events or changes that are expected during the pricing determination period. If the costs allowed are found to be too high or low, then an appropriate adjustment can be made in the following year; or subsequent determinations allow for costs to be adjusted appropriately to account for events that have occurred within the past 12 months.
2. Retail margin with cost pass through mechanism. The onus would lie with a retailer to assess the impact of any unforeseen event and then apply for a pass-through if deemed significant. Of course, the QCA would then assess whether any application was warranted and would make its decision on the actual pass-through required.

In the absence of either of these mechanisms then the QCA should adjust IPART's "benchmark" retail margin to reflect the increased non-systematic risk of retailing to regulated customers in Queensland relative to those in NSW.

6. Network Costs

The QCA is required to adopt a cost-reflective N+R pricing model under which the network costs (N) are to be treated as a straight pass through to customers. In addition, the QCA is required to consider basing notified prices for small customers (those consuming less than 100 megawatt hours (MWh) per year) on Energex network tariffs and notified prices for large customers (those consuming more than 100MWh per year) in the Ergon Energy's distribution area on Ergon Energy network tariffs.

This is similar to the approach for the 2012-13 Price Determination and the QCA expects to deal with similar issues to those that it dealt with in relation to the its previous determination.

6.1 Network Tariffs for Small Customers

Time of Use Tariffs

Only a very small number of customers have so far opted for supply under the residential ToU tariff (Tariff 12). The QCA has encouraged Energex to review its network tariffs to ensure they are sending appropriate pricing signals to customers regarding the differential network costs associated with their time of use.

Origin supports a reasonable price differential between tariff bands to encourage more efficient use of energy. Origin expects that the lack of customer interest in the residential ToU tariff 12 is due to the Government's decision to freeze Tariff 11, making tariff 12 unattractive relative to tariff 11. This anomaly should be addressed as part of the transition back to cost reflectivity. Similarly off peak network tariffs do not provide a reasonable incentive to shift consumption to the off peak period.

While Origin supports more cost-reflective network tariffs, Origin acknowledges that within the current regulated N + R structure this is largely a matter for networks and the Australian Energy Regulator.

Timing of Finalising Network Prices

Origin supports IPART's proposal (September 2012) to the Australian Energy Market Commission (AEMC) in relation to finalisation of network prices to allow greater consultation on retail price changes and for customers to receive earlier notification of the change to their prices. This rule change, if adopted, is unlikely to be before the QCA sets its final retail prices for FY13-14.

In the interim, Origin agrees that the approach proposed by the QCA is the best available, however we propose two amendments:

- that the retail margin be increased to reflect the added risk retailers face that retail tariffs will not be aligned with final network tariffs in the first instance; and

- that the QCA should commit to adopting the final network tariffs in the event that these are released prior to May 31.

Gazetting of Tariffs

Origin supports the QCA continuing to gazette in the steps in block tariffs and service fees as daily rates rather than monthly rates.

7. Other Issues

7.1 Obsolete Tariffs

Origin does not support obsolete tariffs being made available to new customers (including those that were on these). Obsolete tariffs continue to create costs that are spread across all customers and hence minimising the number of customers remaining on these is in the interests of consumers generally. Re-introducing customers to obsolete tariffs delays the removal of these tariffs.

As outlined in Origin's response to the QCA's Transitional Issues consultation paper, Origin believes that in the absence of practical constraints (such as network system complications) a period of 12 months is adequate to allow for a transition from obsolete tariffs (that is, to transition over two price increases instead of one). Origin notes that the QCA increased obsolete tariffs by between 10 and 20 percent in July 2012.

7.2 Community Service Obligations

Origin acknowledges that the redirecting the Community Service Obligation payment from the retail to the network business is a matter beyond the scope of the QCA's delegation. Origin encourages the QCA to continue to assist the Government in addressing this issue. Resolution of this issue is critical to establishing competition in regional Queensland.