29 January 2015

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

Email: electricity@qca.org.au

Dear Mr Hindmarsh

REGULATED RETAIL ELECTRICITY PRICES FOR 2016-17

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

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

Further, Origin notes that the Queensland Productivity Commission (QPC) is also undertaking a review of pricing arrangements in Queensland. Given this concurrent review, it continues to be important that the QCA's review process effectively adjusts retail electricity tariffs to mirror the change in the cost of supplying electricity to regional Queensland customers so that any subsequent methodology amendments or market structure issues identified by the QPC are not compromised.

This submission addresses the questions raised by the QCA in its Interim Consultation and reaffirms that the QCA pricing process should aim to deliver the most efficient, sustainable and competitive electricity industry for regional Queensland.

Pricing Approach and Network Costs

The Delegation issued by the Minister for Main Roads, Road Safety and Ports and Minister for Energy and Water Supply sets out matters the QCA is required to consider. The QCA must use the Network (N) plus Retail (R) cost build up methodology when working out notified prices.

As part of its Delegation, the QCA is required to ensure that regional prices should, as much as practicable, aim to ensure that small customers outside of SEQ do not pay more than reasonable expectations of the prices that would be available to standing offer customers in SEQ.

Origin recognises that the Delegation requires the QCA to consider network charges for 2016-17 only. In this regard, the QCA must consider the use of Energex tariff structures as the basis for flat rate tariffs and Ergon tariff structures for time-of-use tariffs.

Origin encourages the QCA to place greater weighting on the implications of the recent changes to the National Electricity Rules, which requires network businesses to develop individual cost

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reflective tariffs. The approach the QCA adopts this year may influence the calculation of future notified prices and may give rise to transitional issues for Ergon customers due to the disconnect between the regulated retail price and Ergon's network tariffs. We would encourage the QCA and the Government to reconsider the merits of adopting Ergon tariff structures when setting the regulated retail electricity price for 2016-2017. This is particularly relevant to tariff 11 and tariff 20 where tariff structures for Ergon and Energex differ (ie flat vs three-part inclining block tariffs).

With respect to large business customers, Origin supports the continued approach whereby notified prices for these customers are based on the network charges to be levied by Ergon Energy. However, we believe that there is merit in transitioning these prices to more cost reflective levels to satisfy the National Electricity Rules pricing principles.

Energy costs

As part of our submission to the QCA's 2015-16 Retail Electricity Pricing Determination, we proposed a number of ways in which the QCA could enhance its current hedging-based approach that would more accurately capture the wholesale market cost of supply. While we note the QCA did not accept our proposed enhancements, we consider it prudent to summarise our concerns with the approach used in the 2015-16 Retail Electricity Pricing Decision.

In our view, the QCA's hedging based method does not appropriately reflect the dynamic of the wholesale market with respect to the relationship between contract and pool prices. Under the QCA's approach, the portfolio cost is at its lowest under a scenario when pool prices are at their highest and the supply demand balance is at its tightest; conversely, portfolio costs are at their highest under a situation when pool prices and demand are at their lowest.

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

As a result, we maintain our view that it is unrealistic to assume retailers will consistently be able to profit from buying an insurance product and that the higher the pool price scenario, the lower the wholesale energy cost.

In previous submissions, we also raised a number of concerns with the approach taken to generate load profiles. ACIL's presentation of modelled Energex demand simulations in 2015-16 showed that the current approach continues to under-represent load variability. The top 100 hourly demands in ACIL's upper and lower demand simulations sit within the boundary created by the actual demand traces for each of the last four years. We would expect that upper and lower demand simulations would sit outside recent historic demands as they are intended to represent extreme conditions. A tight range of demand distributions naturally leads to a more efficient 'model hedge position' in turn understating modelled energy costs.

Retail costs

As noted by the QCA, an appropriate allowance for retail costs need to be included within the R component of each retail tariff. Retail operating costs and margin need to be set to encourage business efficiencies, new entrants and thus competition in the regional electricity market. If the R component of each tariff is set below a representative retailers cost to serve, competition will cease to progress in the Ergon distribution area and there is little potential for customers to be offered discounts.

Representative Retailer

There appears to be a discrepancy between the QCA's and ACIL Allen Consulting's definition of a 'representative retailer'. The QCA's Interim Consultation Paper proposes that a representative retailer is one that is an 'incumbent retailer of sufficient size to have achieved economies of scale[1]'. In a traditional sense, Origin would interpret this to be Origin, AGL and Ergon Energy. However, ACIL Allen Consulting refers to relying on 'incumbent' and 'non incumbent' (ie Click Energy, Lumo Energy and M2 Energy)[2] retailer data to analyse retailer operating costs.

Origin believes the QCA should be cognisant new retailers are continually entering the Queensland electricity market and may seek to supply customers in the Ergon distribution area and may seek to supply customers in the Ergon distribution area if notified prices move towards cost reflective levels. This is particularly true for customers in Ergon's east pricing zone. The R component needs to reflect that there are small scale retailers and if the allowed costs are not adequate to cover costs, retailers will not offer price benefits to these customers.

Retail operating costs

Retail operating costs (ROC) relate to the costs of the services provided by an electricity retailer to its customers. In order to establish a retail operating cost allowance, the QCA needs to determine appropriate ROC categories and an approach to estimating costs in each of these categories.

ROC should include categories such as billing, customer call centre, credit management, energy trading activities, corporate overheads, IT systems and other costs (ie Ombudsman costs, depreciation). We believe ROC needs to recognise that each retailer has different cost categories in relation to capital and operating costs and Origin believes that both costs need to be recognised. Origin supports ACIL Allen Consulting's proposal to include QCA regulatory fees as a separate ROC item.

In addition, Origin supports the QCA's proposal to include customer acquisition and retention costs (CARC) as part of ROC. The inclusion of CARC is necessary in order to ensure the competitive functioning of the Queensland electricity market.

Origin's preferred approach to determine a representative retailers costs is to use the current Queensland retail operating cost benchmark and to escalate this allowance on an annual basis. To give the QCA confidence in its own benchmark, Origin believes the QCA can construct an indicative retail operating cost for a representative retailer based on indicative data provided by retailers. Origin believes that relying on data provided by retailers to determine an appropriate retailer operating cost is problematic as retailers have different accounting methodologies and how they allocate costs to electricity and gas customer.

The potential to have large discrepancies in supplied operating costs was evident in 2015-16 when the QCA's analysed the actual retail costs for Origin and AGL. Origin Energy's reported costs were $169 per customer in 2013–14 and AGL's reported costs were $102 per customer[3] - these differences arose from how costs were allocated. We thus believe a benchmarking approach with some comparison to actual costs to assure validity is the most effective mechanism to determine these costs.

With regards to the annual change in ROC, Origin suggests that a simple methodology be developed. For example, the QCA's current approach of escalating ROC based on the consumer price index. However, if an annual escalation method is used, then there would need to be a provision to take

[1] QCA, Regulated retail electricity prices for 2016-17, December 2015, p14.
[2] ACIL Allen Consulting, Regulated Retail prices for 2016-17, 2 December 2015, p7.
[3] QCA, Regulated retail electricity prices for 2015-16 – Final Determination, p28.

into account one-off changes to retail costs because of new regulatory or compliance obligations in the Queensland market.

Retail Margin

A retail margin needs to cover a retailer for its risk-weighted investment. A low margin is a significant impediment to the further development of competition and to the future investment in the energy sector in regional Queensland.

Origin thus, supports a retail margin based on a percentage of total costs as previously utilised by the QCA. Origin believes the current margin of at least 5.7 per cent is appropriate.

Other Issues

Headroom

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

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

Cost pass-through mechanism

In terms of the cost pass through mechanism, Origin considers that adopting a consistent approach over time provides predictability for retailers, consumers and stakeholders. For this reason, we consider that the QCA should maintain the existing cost pass-through mechanism in its current form.

Transitional arrangements

We do not agree with the QCA's decision to continue to allow all business customers to have access to transitional tariffs. Notwithstanding that the QCA highlighted that it did not find that there had been a significant increase in customers accessing transitional tariffs, we remain of the view that, with the exception of those customers that have previously made investments in good faith, there is no justifiable reason for these tariffs to be extended to other customers who have not been exposed to the same level risk.

Closing

Origin would be pleased to discuss any matters raised within this response further with the QCA. Please contact me in the first instance on (02) 9503 5674.

Yours sincerely

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