30 July 2004

Lew Owens
Chairperson
Essential Services Commission of SA
GPO Box 2605
Adelaide SA 5001

Dear Sir,

INQUIRY INTO RETAIL ELECTRICITY PRICE PATH - ISSUES PAPER

Origin Energy welcomes the opportunity to respond to ESCOSA's Issues Paper on the Inquiry into Retail Electricity Price Path.

General comments

For several years, Origin and other energy retailers have pressed the case for national consistency and neutrality in the regulation of retail pricing, in support of encouraging competition to the long term benefit of consumers and lowering compliance costs. At present, the long term future of retail price regulation is uncertain, with no agreement as to when, if at all, responsibility will pass from State jurisdictions to the Australian Energy Regulator and, likewise, no commitment as to when, if at all, such regulation will sunset.

In the interim, Origin acknowledges the legislative amendments to the *Electricity Act 1996* currently being pursued by the South Australian Government, to mandate minimum 3-year price paths together with a longer and more formalised public inquiry process.

Within this revised legislative context, Origin is firmly of the view that standing contract prices should continue to be regarded as the "fail-safe" supply arrangement rather than "standard" supply arrangement. We would argue that only the "fail-safe" approach is consistent with meeting the objectives of encouraging the competitive market and providing appropriate consumer protection. In general, the evidence to date is that the "fail-safe" approach better supports the development and consumer acceptance of a variety of market offers and of a vigorous market place.

Against the background of ESCOSA's pro-competitive approach in the 2003 and 2004 determinations and evidence of the success of this approach to date, Origin strongly believes that ESCOSA should seek to maintain this market momentum. Key to this will be ensuring that the returns available to retailers in SA are consistent with those offered in Victoria, the only other state in the NEM that has pursued full retail contestability without a Government risk management scheme.

To this end, Origin urges ESCOSA, in assessing the range of available options, to explicitly consider the basis on which the Victorian Government made its recent decision for a 4-year retail electricity price path.

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Specific comments

The attached response provides Origin's views on the specific issues raised in the Issues Paper.

Origin Energy would be pleased to expand upon any of the points made in our submission. Please contact Matthew Cole on telephone number 03 9652 5820 or myself if you wish to discuss.

Yours sincerely

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ISSUES PAPER
INQUIRY INTO RETAIL ELECTRICITY PRICE PATH

SUBMISSION BY ORIGIN ENERGY

TO ESSENTIAL SERVICES COMMISSION OF SOUTH AUSTRALIA

30 July 2004

Issue 1

The Commission seeks views from stakeholders on the objectives it has stated for establishing a retail price path. Based on the relevant legislation, are there other factors to which it should have regard?

Origin believes that the objectives for the retail electricity price path as distilled by ESCOSA in the Issues Paper are generally consistent with the relevant legislation, subject to two clarifications. First, while it is conceptually attractive for a regulator to seek to determine the "lowest possible price consistent with" the four elements listed, a range of possible prices will inevitably emerge from any analysis and some judgement will have to be exercised to arrive at the standing contract price. As ESCOSA goes about this task, Origin believes that the Commission needs to ensure that it is being even-handed with AGL SA. In addition, the results of ESCOSA's own work on monitoring retail competition justify even greater emphasis on a light-handed and pro-competitive approach, supporting the current market momentum by setting prices towards the upper end of indicated ranges.

The SA electricity market is increasingly competitive[1] with: five retailers actively engaged in making market offers to small consumers; the rate of switching having risen significantly in the first half of 2004 and likely to rise still further in the second half of the year; and significant savings on offer for consumers who shop around. The commencement of gas FRC on 28 July will also enhance competition in electricity through the advent of dual fuel offers.

These very positive signs regarding electricity retail competition are, Origin believes, largely due to the pro-competitive stance that ESCOSA took in its 2003 and 2004 retail price determinations. Now that ESCOSA is charged with the responsibility of determining a retail price path for not just one year but a minimum of three years, it is more important than ever that the Commission maintain its pro-competitive stance, so as to enable the market to continue to evolve from nascent to mature competition.

Second, ESCOSA has stated that it is seeking to set prices that provide an "appropriate" return for an efficient declared retailer. Following section 3.4.5 of the Terms of Reference, Origin presumes that ESCOSA will determine what constitutes an appropriate return "having regard to the entity's investment in the business, the risk of standing contract retailing in South Australia, and the equivalence with standing contract retailer margins interstate without Government risk management schemes."

Issue 2

What form of regulation/price path should the Commission adopt?
What correction factors and rebalancing parameters, if required, should the Commission consider or allow?

Although full retail competition only started a year and half ago in South Australia, the available evidence indicates that competition is developing at a pace consistent with other liberalised energy markets[2]. To enable this trend to continue, and to accelerate, Origin believes that ESCOSA should take as light handed an approach as possible, subject to the requirements of the soon-to-be-amended Electricity Act.

Against the background of the Victorian and NSW approaches to designing retail price paths in electricity and gas and the discussion of alternatives in those contexts, Origin understands that there are three main options for the form of the price path, each of which can be implemented with a varying array of constraints, pass through provisions and re-opening rights.

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[1] This is evident in ESCOSA's May 2004 *Monitoring the Development of Electricity Retail Competition in South Australia Statistical Report*.
[2] Ibid.

- N + R — IPART's chosen methodology for electricity in which "target levels" for tariffs are determined for each year in the price path with respect to network tariffs (N) and retail cost (R) and a transition path is then set to move from current to target levels using various combinations of CPI-X applying overall or just to R, and price constraints on individual bills, tariffs and/or tariff components ;
- Weighted average price cap - the Victorian Government's chosen methodology for electricity and gas in which the price path is expressed in terms of the average retail tariff for standing contract customers, determined via a forecast cost build-up (analogous in concept to the N + R target levels), and the path is adjusted over time according to CPI-X, subject to re-opening in the event of pre-specified trigger events giving rise to benchmark returns outside a target band and with a variety of constraints potentially applying at the individual tariff level; and
- CPI based threshold approach – IPART's chosen methodology for gas in which weighted average retail prices are allowed to increase at CPI+0 (by default) over the duration of the price path, subject to some rebalancing constraints, and the standing contract retailer has the option of seeking a review by the regulator if proposing an above CPI price rise.

In choosing between these options, it is not the case that one approach is universally better than the others. In fact, the three approaches, at least as applied in Australia, all involve a cost build up in the first instance, and it is only once these reference points are established that the final form of the price path is often determined. For electricity standing contracts in South Australia, Origin's view is that the form of the price path needs to be responsive to the context and should:

- provide for cost reflective prices on average across standing contract consumers at the commencement of the price path regime;
- be fully flexible with respect to rebalancing to allow the standing contract retailer to achieve cost reflective individual tariffs as quickly as possible — otherwise the development of retail competition may be distorted;
- account for the key aspects of the SA electricity environment, such as the peaky and volatile nature of demand (which feeds through into volatile spot and contract electricity prices) and the absence of a Government risk management scheme (such as NSW's ETEF) — this makes accurate forecasting of energy costs for the purposes of a medium term price path a fairly imprecise exercise;
- recognise, more generally, the impact of a range of uncontrollable factors on the standing contract retailer's costs (such as network tariff pass throughs, tax changes etc);
- serve to provide a transparent and reasonably predictable fail-safe benchmark against which consumers can evaluate market offers; and
- minimise the regulatory burden associated with determining standing contract prices and, by suitable design, limit the need for full or partial re-opening of the price path before its conclusion to only exceptional circumstances — there is a strong argument for setting a price path that is robust to variations in underlying costs within pre-specified bounds on benchmark returns.

Regarding the duration of the price path, Origin notes that the Terms of Reference require that it be for a minimum of three years. At this stage, Origin does not have a definitive position regarding whether or not the price path should exceed three years, but notes that the NSW electricity price path is of 3 years duration, ending in June 2007, while the Victorian electricity price path is of 4 years duration, ending in December 2007. Origin believes that the optimal duration for the SA electricity price path will depend on the overall form of the price path and that ESCOSA should therefore consider the two issues in tandem.

Issue 3

What methodology should the Commission use to obtain estimates of wholesale electricity costs for a future three-year period?
What modifications to the approach adopted by IES in estimating wholesale energy costs in the 2002 and 2003 reviews should the Commission adopt?

Origin believes that ESCOSA should primarily rely on some form of prudent (notional) cost methodology to estimate wholesale electricity costs for the purposes of a minimum 3-year price path. Although Origin does not endorse either the IES methodology previously used by ESCOSA or the Charles River Associates methodology used by the Victorian Government, these styles of analysis are nonetheless well suited to a regulatory context. While clearly abstractions from reality, they are capable of capturing the key aspects of a prudent hedging strategy, can incorporate current market pricing data (such as the AFMA forward curve), and provide a reasonably high degree of transparency, having regard to the inherent complexity of the exercise. The uncertainty associated with medium term forecasts from these sorts of models is an artefact largely of the horizon rather than the fact that a notional model was used as the estimating tool.

Origin intends providing ESCOSA with further comments on the estimation of prudent wholesale electricity costs in the near future. These will address, for example, the failure of the existing models to adequately recognise the significant impact on hedging practices and compliance costs, flowing through into estimated wholesale electricity costs, of the standard risk management regimes that all (prudent) retailers use to constrain their exposures to potential electricity trading losses.

Although the Terms of Reference require ESCOSA to have regard to "the electricity entity's actual underlying wholesale electricity contracts, hedging strategies and other arrangements for securing supply in South Australia" Origin believes that some caution is necessary in seeking and making use of this information in the regulatory process. There are three main reasons for this. First, the reality of actual hedging activity in the electricity markets is much more complicated and dynamic than indicated by the abstract models used to estimate prudent wholesale electricity costs. Second, to the extent that ESCOSA were to base its assessment of wholesale electricity costs on AGL SA's actual contract positions and hedging practices, the Commission may inadvertently undermine the incentives on AGL SA to be efficient in this regard. Third, details of AGL SA's contract positions constitute highly sensitive market intelligence and are subject to tight confidentiality agreements with counter parties.

Origin has noted that the minimum requirements that ESCOSA has set for AGL SA's pricing proposal, while requiring some information on actual wholesale electricity costs and the assumptions underpinning forecast costs, do not require AGL SA to provide its contract book to ESCOSA. Rather, ESCOSA is seeking information at a summary level, with an explanation as to how the data and forecasts were compiled.

Issue 4

Are there other approaches that the Commission should consider in setting a retail price path?

Origin is satisfied with the building block approach as the primary means of setting the retail price path. Comparing net payments (retail tariffs minus network tariffs) between AGL SA's standing contract customers and similar customers in Victoria, as ESCOSA did in its 2004 determination, provides only a rough and ready indication of whether standing contract prices are set appropriately in South Australia, with many important factors not taken into account. For example, SA's peaky load profile and relatively frequent interconnector constraints would be expected to result in a higher wholesale energy cost than in Victoria, all else the same.

The alternative approach of comparing net payments between AGL SA's standing contract customers and current market offers in South Australia, as discussed in IPART's review of ESCOSA's methodology, may be useful in so far as providing some comfort that the standing contract price is not set below market offers. However, given the "fail-safe" role of the standing contract price, and the obligation on AGL SA to allow all small consumers to receive supply at that price, it would be both extremely detrimental to retail competition and unfair towards AGL SA to use market offers (which largely reflect new entrant pricing) to set the standing contract price, per se.

Issue 5

How should the Commission, in setting a price path, treat actual and prudent costs?

Building on our response to Issue 3, in relation to estimating wholesale electricity cost, Origin believes that the emphasis that should be placed on actual versus prudent costs will vary according to which element of controllable cost is being discussed. Where robust benchmarks are available, which capture the key aspects of providing standing contract supply in a South Australian context, a prudent cost estimate should serve as the primary input for the building block process (which is desirable from the viewpoint of providing efficiency incentives). Actual costs would then be used to provide a secondary check on the reasonableness of the prudent cost estimate. However, in the event that a benchmark estimate is unavailable, unreliable or inexplicably at variance with actual cost data, the need to ensure the financial viability of the incumbent retailer makes it more appropriate to rely to a far greater extent on actual cost data.

In making use of a mixture of actual and prudent cost data, one of the most important issues for ESCOSA will, of course, be to ensure that both are compiled on a consistent basis, so as to compare like with like. To date, no regulator in Australia appears to have adequately addressed this and it has made the task of agreeing on appropriate retail operating costs and net margins, in particular, a difficult and at times opaque exercise.

Having regard to these considerations Origin recommends that:

- wholesale electricity costs be set primarily with reference to prudent costs (for the reasons given in response to Issue 3); while
- retail operating costs be set with significant emphasis on actual costs — due largely to the lack of robust benchmarks and the significant differences between available benchmarks (in many cases) and the actual costs reported by the standing contract retailer.

In relation to the net margin component of controllable costs, it is not clear that actual net margins provide a useful reference point because they are essentially a product of the existing retail tariff regulation. Origin contends that the net margin should therefore be set primarily on a prudent cost basis, with careful attention to the risks inherent in the South Australian regulatory and market context, together with the additional risks imposed by moving from a 1-year to a minimum 3-year price path regime.

Issue 6

What factors should be taken into account by the Commission in establishing a price path re-opening mechanism?

Drawing on our response in relation to the form of the price path (Issue 2), Origin believes that it is desirable to choose a design that limits the need for full or partial re-opening of the price path before its conclusion to only exceptional circumstances. If appropriate pass throughs are allowed, such as for network tariffs or tax changes, then this would shorten the list of factors that would likely trigger a re-opening (leading ultimately to a re-determination of the price path).

To balance considerations of price predictability for consumers against the legitimate interests of AGL SA in terms of passing through uncontrollable increases in its costs, there is a strong argument for setting a price path that is robust to variations in certain underlying costs within pre-specified bounds on benchmark returns. This style of re-opening right underpins the recently established 4-year price paths for Victorian electricity and gas.

Issue 7

Should the Commission regard the standing contract price for small customers:

- **As a "fail-safe" standard: with regard being had to the fact that market offers should be better than the standard contract price and customers seeking a better price should move to a market contract; or**
- **As the "standard" supply arrangement: with no regard to the price having an impact on market development.**

Origin is firmly of the view that standing contract prices should be regarded as the "fail-safe" supply arrangement and, indeed, that this view is broadly consistent with the approaches adopted recently in Victoria and in previous determinations (by ESCOSA) in South Australia. The evidence to date supports the view that these are the states with the highest inter-retailer churn rate and most active participation of non-incumbent retailers in the market with the broader ranger of competitive product offerings. In parallel, customers in these markets have been encouraged to seek out market contracts.

Given the benefits of the "fail-safe" interpretation of standard contracts in terms of the vigorous development of the competitive market place, we are particularly concerned that the proposed implementation of a price path regime with no pre-specified expiry date, together with the requirement for no specific allowance for headroom (as set out in the Terms of Reference), may be seen as an indication that the resulting standing contract prices will be the standard form of electricity supply to small customers in the long term.

It is Origin's view that the recent agreement between incumbent retailers and the Victorian Government on the 4-year Victorian retail electricity price path was totally consistent with the "fail-safe" interpretation as the overarching philosophy. For instance, the Victorian Government's fact sheet states that, "The changes apply to the 2004 standard prices of electricity and gas retailers for consumers who decide not to take advantage of market offers made by electricity and gas retailers under full retail competition."[3] The clear implication from this is that the Victorian Government anticipates that consumers in general will have access to market offers that are competitive with standing contract prices.

Issue 8

How could the Commission improve its ability to estimate demand parameters? What other approaches, such as sensitivity analysis, could the Commission use to manage this uncertainty?

Origin intends to address these issues as part of the further comments it will provide regarding the estimation of prudent wholesale electricity costs (refer to our response to Issue 3). In relation to sensitivity analysis, while we will detail our position in due course, Origin believes that Monte Carlo methods, for example, could be applied to enhance the statistical robustness of the current estimation methodologies, to account for the uncertainty surrounding a number of influential factors.

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[3] Victorian Government Fact Sheet – Key elements of the 2004 energy pricing decision, www.doi.vic.gov.au

Issue 9

What additional information should be requested from AGL SA to assist the Commission in its evaluation of the price path proposal?

Origin supports ESCOSA's approach of specifying a minimum level of information for AGL SA to submit and allowing for a public as well as a confidential component. The scope and nature of information being requested appears appropriate at this stage.

Issue 10

What approaches, other than the building block approach, could the Commission consider in reviewing and setting a price path for the next three years?

Please refer to Origin's response to Issue 5.

Issue 11

Is there any additional information the Commission should seek from AGL, which would assist the Commission in this Inquiry?

Please refer to Origin's response to Issue 9.