15 October 2004

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

Dear Sir,

INQUIRY INTO RETAIL ELECTRICITY PRICE PATH - DISCUSSION PAPER

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

General comments

This response builds on Origin's earlier submission in response to ESCOSA's June 2004 Issues Paper. Now, as then, Origin believes that the best way to promote the long term interests of electricity consumers is to set standing contract prices that are consistent with the continued development of retail competition. Ultimately, Origin believes that the innovation and efficiency that results from robust competition will far outweigh the extra administrative costs of establishing FRC.

In going about its task, Origin generally supports ESCOSA's approach of maintaining consistency with its previous decisions unless there is compelling evidence to change its position. Nonetheless, the three year price path that ESCOSA determines will be highly influential in shaping the nature and extent of continued retail market development, and this needs to be carefully considered in the decision making process.

SA electricity customers are already starting to benefit from a vigorous competitive market with innovative market offers, and it is important that these gains are not jeopardized by changes in regulatory approach.

Specific comments

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

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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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DISCUSSION PAPER
INQUIRY INTO RETAIL ELECTRICITY PRICE PATH

SUBMISSION BY ORIGIN ENERGY

TO ESSENTIAL SERVICES COMMISSION OF SOUTH AUSTRALIA

15 October 2004

Timetable for the inquiry

Issue 1

The Commission seeks any views about the timing of its implementation of a price determination following the conclusion of this Inquiry, and whether stakeholders believe there is a need for a long period of consultation on its report and draft determination.

Origin is somewhat surprised that ESCOSA is apparently unable to issue a bridging price for the period 1 January 2005 to 30 June 2005. This appears to be an anomaly in the amendments to the Electricity Act and cuts across one of the key motivations for those amendments; to provide for a longer period for public consultation and regulatory decision making.

Taking as given ESCOSA's interpretation of the Electricity Act, Origin believes that the Commission's proposed approach is appropriate in the circumstances. That is, depending on whether ESCOSA's price analysis (to be completed in November 2004) indicates a significant change in prices, the Commission will either allow further consultation and make its final report in March 2005 (small change) or implement immediately from 1 January 2005 (large change).

Notwithstanding this, Origin believes that hastening consultation and decision making in the face of the apparent need to make significant price changes extending over a 3 year price path is fraught with danger, and we would hope that either some avenue could be found under the Electricity Act to allow for a bridging price, or that the SA Government could overcome the current legislative problem.

Form of the price path

Issue 2

To what measure should any price path control be applied, ie, average revenue per customer or per MWh, weighted average tariffs, individual tariffs, etc?

Origin's view is that the price path control should be expressed at a high level, on either an average revenue or weighted average tariff basis. There are good arguments for both measures, and Origin notes that AGL SA has requested an average revenue per MWh control.

Is it necessary to control changes in both the supply charge and energy charges (as it would be possible for AGL SA to increase supply charges significantly and reduce energy charges while still maintaining the allowable average charge, thereby impacting more severely on small consumers)?

Now that all electricity customers are free to choose their retailer, the price path controls for standing contract supply need to recognise the commercial imperative of structuring prices on a cost reflective basis, and the market pressure to retain them at such levels.

Origin believes that retailers should have the ability to recover fixed costs (eg from network charges) from all customers. In other words, the supply charge should be cost reflective.

What flexibility should AGL SA be given to change individual tariffs (increasing some, reducing others, but within the overall average price constraint)?

In general, Origin believes that AGL SA should not be subject to constraints on individual tariff movements because AGL SA will be held to cost reflective tariffs by virtue of competition in the retail market. Origin notes that AGL SA has actually proposed a CPI+5% cap on the movement in individual tariffs, and believes that against the background of AGL SA's proposed price path (which is essentially increasing at CPI in each year) this cap is reasonable, and consistent with other regulatory regimes.

Given the complexities outlined above, is there a preferred approach to controlling tariffs to ensure compliance under the price path and protect individual consumers?

As discussed above, Origin believes that, in the context of full retail contestability, it is unreasonable to prevent AGL SA from structuring its tariffs to be cost reflective. A high level price path control should be set and below this competition in the retail market provides an effective constraint on how AGL SA can structure its standing contract prices.

Issue 3

Is it appropriate for the price path to be reopened in the case of significant deviations between actual and expected wholesale energy costs or consumption levels, or should the risk of such fluctuations be borne by AGL SA in the interests of securing a more certain price path?

Origin supports these bases for a re-opening of the price path. Although it is conceivable that AGL SA could bear these risks, the associated cost (risk premium) may be very large and may not represent good value for standing contract customers. Nonetheless, as AGL SA would face the risk of deviations up to the level considered by ESCOSA to be "significant", some recognition of the additional risk, and/or the cost of risk mitigation to AGL SA, is necessary in setting the net margin.

In the event of a reopening, should the review be limited only to those components of the price that triggered the reopening, or should a more comprehensive review be undertaken at that point?

Given that one of the key benefits of a price path is the stable reference point that it provides for small customers, Origin's view is that, in the event of a reopening, the review should be limited rather than comprehensive, and be progressed in an expeditious manner. As the price path is to be of only three years duration, a comprehensive review is likely to take too long and most inputs will not have changed sufficiently to justify the costs of the exercise. To make a limited reopening procedurally efficient, the mechanism for how the review would occur should be pre-specified and include the evidentiary requirements that AGL SA has to meet.

How often should a re-opening of the price path be allowed?

Origin believes that AGL SA should be allowed to seek a re-opening of the price path at any time. Given that the trigger for the re-opening would have to satisfy whatever limit is pre-specified as being a "significant deviation", it would be unreasonable to force AGL SA to wait for the end of the financial year to adjust prices if this is supported.

Which parties should be able to seek a re-opening?

To some extent this is dependent on the regulatory approach and the residual balance of upside and downside risks. If the approach is to set a price based on the lower end of the reasonable range from the building block analysis, then re-opening should be solely at AGL SA's discretion.

Issue 4

Does the list of pass-through items proposed by AGL SA accurately reflect the costs that are entirely beyond AGL SA's control and for which it is appropriate that consumers, rather than the retailer, bear the risks?

Origin supports AGL SA's list of pass through items. All items on the list are outside AGL SA's control and, in the context of a three year price path, it is appropriate that consumers face the costs associated with these.

Issue 5

Should the Commission support continued efforts to remove cross-subsidies between consumer tariff categories and within tariffs?

See our response to Issue 2.

Should the Commission attempt to control the allowable changes for both supply charges and energy charges within a tariff category?

See our response to Issue 2.

What level of price increase is tolerable for customers who are currently on under-recovering tariffs? Is the NSW rebalancing restriction acceptable?

Origin notes that AGL SA has proposed a CPI+5% cap on the movement in individual tariffs, and believes that against the background of AGL SA's proposed price path (which is essentially increasing at CPI in each year) this cap is reasonable. As previously indicated, Origin does not support a constraint on changes in supply charges and energy charges, and for this reason the NSW rebalancing restriction is not supported. This restriction works at the level of each customer's bill and may substantially delay AGL SA in moving some of its under recovering tariffs to being cost reflective.

We note for instance that at the end of the last retail price path in NSW, many tariffs were still under recovering, and some of these will remain so even at the end of the price path that commenced on 1 July 2004. This will bias the emergence of a truly competitive market in NSW.

Are there alternative approaches to setting a "Socially Responsible Tariff" as proposed by CCSA, that overcome the problems identified?

Origin agrees with ESCOSA's comments in relation to addressing social issues through utility tariffs:

> "The commission is concerned that attempts to address social inequities via tariff structures run the risk of causing additional pain to some needy families and rewarding others who are quite capable of paying the true cost of their consumption." (Discussion Paper, p.25)
>
> "Whilst the process of determining eligibility for the concession is difficult to target precisely to those in need, it is in the Commission's view preferable to attempting to do this via tariffs." (Discussion Paper p.26)

Overall, Origin believes that Government should address concerns over the affordability of energy supply by subsidising the price of energy. This should be done directly, via a payment from Government to the energy supplier in respect of those customers assessed as needing assistance. The energy company would then pass this assistance through to the identified customers. Origin, like AGL SA, has comprehensive hardship policies in place to assist customers who have difficulty in paying their energy bills.

Wholesale electricity cost

Issue 6

Are the scenarios developed by ACG credible and appropriate?
Are the assumptions used by ACG credible?

While recognising that the exercise would be an abstraction from reality, Origin is concerned that ACG's modelling considered only five scenarios. We believe that a more appropriate industry standard approach would rely on the simulation of thousands of scenarios based on empirical probability distributions to determine the extent of risk exposures. As part of this, 1 in 20 year weather and other extreme events would also be considered. A prudent retailer would use this approach to set risk limits, which would in turn affect hedging requirements. Consequently, Origin considers that the ACG scenario analysis is unrealistic, in that it does not capture the full range of risks that retailers have to manage, nor does it account for how risk limits are typically applied.

Which of the three future contract price options is preferred for setting the WEC, and on what basis?

At a high level, Origin supports ACG's approach of estimating the WEC by combining AGL SA's pre-existing hedge position with an estimate of the cost to hedge the load not already covered. Origin notes from ACG's report that the existing hedge portfolio is such that AGL SA "does not need to purchase much additional contract cover" (p.29) in respect of 2005/06 and 2006/07. Consequently, it is largely in respect of 2007/08 that significant differences emerge in between Contract Cases A, B and C.

In principle, Origin supports the use of an appropriately calculated LRMC (equivalent to new entrant pricing) to inform the wholesale electricity cost allowance. LRMC, or new entrant pricing, is advantageous in the SA context because it overcomes the problem of the illiquidity of the contract market and is not influenced by AGL SA's contracting behaviour. In addition, LRMC is clearly consistent with providing signals for new investment in generation and/or interconnection. However, as noted below, Origin has some concerns in relation to the ESIPIC estimates of LRMC.

Issue 7

Are the assumptions used by ESIPC appropriate?

ESIPC's analysis of LRMC is focussed solely on the supply side. It assumes that generation will be available to meet the expected demand. It also assumes that risks are covered in the process of matching supply to demand. The market risks faced by generators with respect to price are not taken into consideration. For example, a generator needs to recover the cost of transmission failures, which may impact on several generators simultaneously and lift price leaving the generator exposed to the market. There are also fuel supply risks such as the recent failure at Moomba. The assumption that the units will not be duel-fuelled adds to the risk.

The gas price assumption in the LRMC is very conservative (on the low side). A reliable gas supply for a unit running 1% of the time would greatly exceed the assumed $4/GJ. It is also not clear whether gas price is escalated by CPI, or by some other factor, over the life of the project life.

What is the appropriate rate of return for investment in generating plant for use in determining the LRMC?

The rate of return put forward in the ESIPC report is inadequately justified (there is no explanation regarding the source of key parameters such as the equity beta and debt premium) and it is difficult to understand how it is translated into the analysis. Indeed, it is not immediately apparent as to why the Project IRR (real) as provided in footnote 2 is different from the pre-tax real WACC presented in Table 4-5. The comments in footnote 2 make it unclear as to whether corporate income tax is taken into account in the calculation of LRMC.

Given the significance of the cost of capital to the LRMC estimate, Origin would like to see a more detailed explanation provided together with a wider range of sensitivities. After all, in its return on investment analysis of the net margin, ESCOSA uses a range of plus or minus 1.5% around the ESIPC's base case rate of return.

Issue 8

The Commission encourages stakeholders to review the ACG and ESIPC reports released with this Discussion Paper, and to provide comments to the Commission on the credibility of those assumptions. The Commission will take account of all comments received in making its final determination of WEC in November 2004.

Specific comments on ACG report

- Use of AFMA pricing curve (p.19 and p.28) – when using AFMA data, Origin believes that $3-4/MWh needs to be added, encompassing both a premium for significant market purchases (which is related to the lack of liquidity in the SA contract market), and a premium on the AFMA median prices to cross the bid/offer spread.
- Scenario analysis (p.25) – as discussed under Issue 6, Origin believes that the ACG analysis is too simplistic, as it does not model exposure to extreme weather or other events, nor does it consider the risk limits that businesses typically impose to manage such exposures.
- Guidelines for contract cover (p.26) – ACG has assumed that "swap cover will be purchased to at least the level of the average load in each quarter." Origin believes that this assumption will lead to over-contracting in off peak periods and hence there is a need to allow some cost for hedge mismatch.
- Cost of RECs (p.30) – Origin has sought to confirm the REC costs derived by ACG and believes that for 2006/07 and 2007/08 the forecast costs are too low.

Specific comments on ESIPC report

- All market risks faced by generators and therefore recoverable costs of supply are not accounted for in assuming supply is available to match demand (p 4). Having supply available to match the load profile accounts for quantity risk (assuming little variability in half-hourly forecast demand) but it does not account for other market risks such as price risk, fuel supply risks and transmission failure risks.
- The sensitivity analysis of a 5% fuel price increase is ineffective; 25% is more appropriate for peaking generators seeking firm gas supply(p.5). Another $1/GJ adds about $12/MWh to LRMC.
- The assumed 25 year project life may be too long for open cycle turbines. However, to some extent, this concern is addressed by allowing for major maintenance after 15 years.

Retail operating costs

Issue 9

Are there opportunities for stapled distributors /retailers to achieve lower costs than standalone retailers?

Origin believes that there is some scope for cost sharing between the distribution and retail parts of stapled businesses. However, we have been concerned for some time about the lack of clear ring-fencing guidelines and accountability in allocating costs in jurisdictions dominated by stapled businesses. Consequently, benchmarks from such jurisdictions would be artificially low.

What are the most appropriate benchmark estimates to use for the current review?

Origin believes that the Victorian regulatory environment provides the most appropriate reference point for setting retail operating costs as the market structures are more similar than in other states (dominated by government owned, stapled businesses). The Victorian Government allowed $90 (including $10 of FRC costs) per customer (in 2003 dollars) in the 2004-2007 price path agreement with Victorian retailers. Origin maintains its view that ESCOSA's 2004 benchmark of $82 per customer (including FRC costs) is below the actual cost of serving standing contract electricity customers.

How should retail operating costs for AGL SA be set in relation to these benchmarks?

This depends on the approach to benchmarking operating costs. If the Victorian approach is adopted then we suggest that, to the extent that AGL SA's actual costs differ materially from the available benchmarks, then it is incumbent on ESCOSA to work with AGL SA to find out why this is.

Should retail operating costs be inflation and efficiency adjusted within the medium-term price path?

The majority of retail operating costs are labour-related and are therefore likely to escalate above the rate of inflation (CPI). Indeed, average weekly ordinary time earnings usually increase at approximately CPI+1%. If AGL SA is assumed, all else the same, to be improving its efficiency each year, then it may be reasonable to assume that retail operating costs increase at or around CPI each year.

Net margin

Issue 10

Are the assumptions used to derive AGL SA's working capital reasonable? Are there any other factors that the Commission should consider in determining the relevant amount of working capital required by AGL SA as standing contract retailer?

In the broad, ESCOSA's approach to deriving AGL SA's working capital requirement appears plausible, but the assumptions should be checked with AGL SA. Pending this, and given that very little detail is provided as to how the Commission translated its assumptions into a spreadsheet model, Origin is unable to determine whether the estimated working capital allowance is appropriate.

Issue 11

Should the purchase price be considered as an investment for the purpose of determining the retail margin for AGL SA?

In the context of retail competition, it is conceptually legitimate for an incumbent retailer to regard the market value of the "franchise" customer base as an investment that requires a rate of return to shareholders. As the retail operating cost allowance excludes marketing costs not associated with standing contract customers, there will be no double counting of the marketing costs avoided by dint of franchise customers being relatively "sticky". In view of this, if the value of the customer base is not accounted for in the net margin then non-incumbent retailers may find it difficult to compete as they have to incur the additional marketing costs to actually win customers.

If so, does the range $138m to 167m represent a reasonable value for the efficient level of investment to be used in this analysis?

Based on the price that AGL SA paid for its franchise customer base, the range of $138m to $167m is an obvious reference point for the efficient level of investment to be used in the analysis. However, given the significantly higher prices paid in Victoria on a per customer basis, it is conceivable that the true value of the small customer base in SA is in fact much higher. As a matter of principle, it should be the current market value of the franchise customer base that should be used in the analysis, which may differ somewhat from the historical cost.

Issue 12

What is the relevant rate of return that should be used to derive the return on investment for AGL SA?

Origin supports the use of a range for the rate of return centred on a benchmark return for a new entrant generator. However, as noted under Issue 7, Origin does not believe that ESIPC has substantiated its estimate of the new entrant rate of return, and ESCOSA should seek to address this problem if the Commission wishes to proceed further with this analysis.

Issue 13

Is the above provision for amortisation credible, or should the amount in AGL SA's annual accounts for depreciation and amortization be used to set the appropriate level of return of investment, or is an alternative approach preferred?

Origin is not well placed to comment on which basis is more appropriate for amortisation. If AGL SA has good reasons for the higher amortisation figure then that figure should be considered by ESCOSA.

Issue 14

Should bad debts be included in the retail margin calculation or should they be allowed for within the operating cost?

Whether bad debts are included in the retail margin or retail operating costs is largely a matter of consistency. In describing the benchmarks for retail operating costs, and AGL SA's actual costs, ESCOSA was very clear in the Discussion Paper in saying that bad debts were not included. Consequently, if they are moved out of the net margin then they need to be explicitly added to the retail operating cost allowance.

What level of bad debts should be assumed in the future?

The increase in bad debt allowance proposed by ESCOSA seems plausible, but Origin would expect that AGL SA's recent experience would provide a better starting point.

Issue 15

Are the assumptions used in the Commission's estimate of the quantum of justifiable retail margin credible?

Origin believes that, although some of the inputs used appear plausible, ESCOSA's analysis requires validation of some key assumptions by AGL SA, is not comprehensive (inadequately dealing with some risk exposures) and more generally is fraught with difficulty in terms of determining reasonable estimates for some highly influential items. Consequently, Origin is concerned that the indicated range of the net margin is too low and that, more generally, this style of analysis may not be compelling, even if the shortcomings identified are addressed.

Is the current 5% on total costs margin still appropriate, or should the Commission adopt an alternative margin for the price path period?

Origin maintains its view that 5% represents the minimum commercially viable net margin for standing contract supply. Neither ESCOSA's return on investment analysis (due to its shortcomings), nor the argument in relation to network charges (because higher network charges necessitate higher allowances for working capital and bad debts), provides a basis for moving away from the current benchmark. Indeed, Origin believes that, to the extent that the introduction of a price path places greater risk on AGL SA as compared to the annual tariff review process, a 5% net margin is at the low end of the reasonable range, and ESCOSA may be justified in adopting a net margin between 6% and 7%, as contemplated in the Discussion Paper.