origin

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The Australian Energy Market Commission
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REVIEW OF EFFECTIVENESS OF COMPETITION IN GAS AND ELECTRICITY MARKETS IN SOUTH AUSTRALIA – FIRST DRAFT REPORT

Origin Energy (Origin) welcomes the opportunity to comment on the Australian Energy Market Commission's (AEMC's) *Review of the effectiveness of competition in electricity and gas retail markets: First Draft Report* (Draft Report) released by the AEMC on 4 July 2008.

Origin is pleased to see that the initial findings of this comprehensive review are that competition is highly effective in the electricity and gas retail markets in South Australia.

Origin, as an incumbent gas retailer and competitor for electricity in South Australia is well placed to comment on the level of competition and agrees with much of the evidence in the draft report. Primarily, Origin supports the findings that there:

1. has been considerable retailer rivalry.

   This is clearly demonstrated by the high level of customer switching seen in the market and the extent to which new entrant retailers have competed with incumbent retailers. As noted in the AEMC Draft Report approximately 66% of electricity customers and 59% of gas customers are now supplied under a market contract;

2. is a high degree of customer awareness about retail competition.

   The take-up of market contracts in South Australia shows that customers are able to access product offers in the energy market while the emergence of new product comparators, to go along that provided by ESCOSA, suggests that customers are readily comparing available product offerings.

   The consumer research report prepared by McGregor Tan Research for the AEMC highlights this level of awareness; and

3. that there are no barriers to energy retailers for entry or exit to the market and that the current structure in the electricity and gas retail markets has supported competition.

   There are no structural barriers within the electricity market and no major impedances to gas competition in the South Australian markets. Origin concurs

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that there are short term hindrances to gas retail competition in some regional areas of South Australia and these are discussed further below.

Origin therefore agrees with the AEMC's positive view of competition in the South Australian energy markets and concurs with most of the conclusions reached in the draft report.

Consequently, this submission does not seek to restate the arguments made in Origin's previous submission to the AEMC's Issues Paper. Instead, this submission focuses on several findings of the AEMC has in its draft report that Origin feels need further clarification or support.

Australian Emission Trading Scheme

Origin is pleased to see that the AEMC has considered the potential impact of the Carbon Pollution Reduction Scheme (CPRS) on both energy prices and energy retailers.

The conclusion that the deregulation of retail energy pricing is essential in order to allow the cost of carbon to be passed through to customers is fully supported by Origin which has made similar representations to the Federal Government's carbon policy development.

The removal of price regulation is also essential for any energy efficiency policies if they are to influence the behaviour of end use customers.

Vulnerable Customers

Origin fully endorses that the AEMC has divorced the issue of hardship and vulnerable customers from the discussion on competition and price deregulation.

Energy affordability and customers in financial hardship is a significant issue but Origin has made previous submissions to the AEMC's Issue Paper and throughout the review of competition in Victoria which highlighted that Origin, and other retailers, provide comprehensive hardship programs to assist vulnerable customers and that assisting customers in financial difficulty is a responsibility shared across all relevant stakeholders.

In particular though, it is Government that bears the responsibility for ensuring that assistance is available for customers who cannot pay for their ongoing energy use. This service must be dealt with through targeted and transparent community service obligations and Government schemes rather than by incorporating them into far-reaching regulations that have the potential to distort the effective operation of the energy markets.

Origin would stress that the removal of retail price regulation will not reduce protection arrangements for customers in financial hardship nor any community service obligations.

Reduction in Competition

The AEMC has noted that some retailers:

- have indicated that they are reducing marketing activities at the current time;
- appear to be reducing the currents discounts on their product offerings; and
- have postponed their plans to enter into the South Australian markets.

Origin supports the finding of the AEMC's that this reflects the recent changes in supply costs relative to the standing offer price.

Retailer activity is cyclical but wholesale gas and electricity prices have been both high and volatile, with a good deal of uncertainty about the direction of future prices over the length of any retail market contracts. Retailers, consistent with their risk policies, will choose to adjust their marketing and discounting activity during periods of volatility.

As such, Origin agrees with the AEMC's analysis and findings that retail margins are under pressure and if standing contract prices cannot accommodate higher input costs then retailer viability and retail competition in South Australia are at risk.

Wholesale Electricity Market

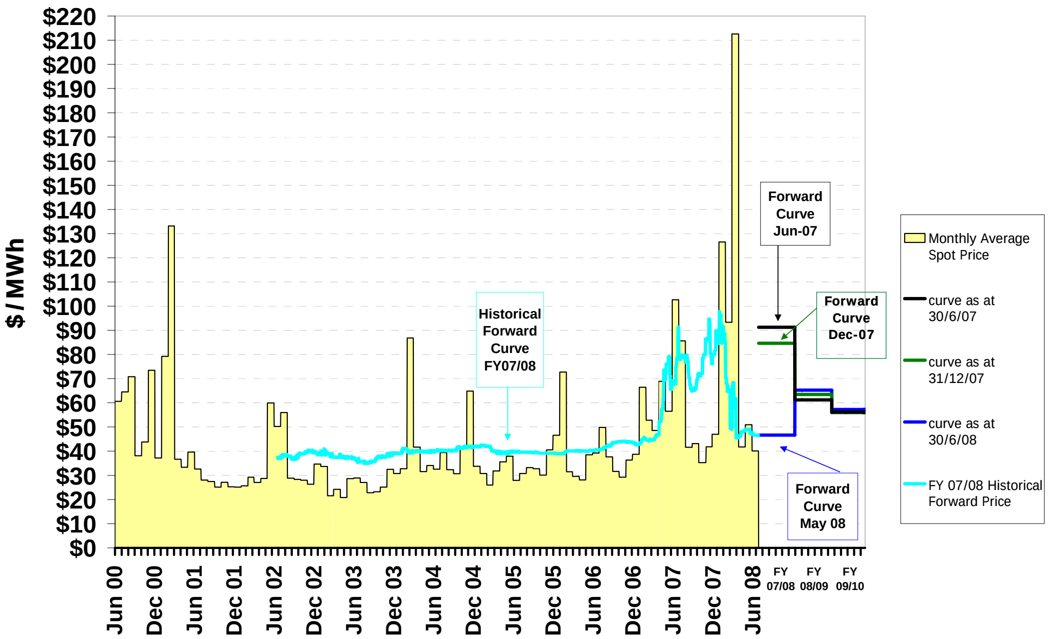
The AEMC states in its Draft Report that;

The recent tightening of the supply/demand balance in the wholesale electricity market has contributed to increases in spot and contract prices,...[1]

The Draft Report also poses an open question as to whether or not AGL's ownership of Torrens Island Power Station (TIPS) has any effect on ongoing competition. The Draft Report notes that the bidding behaviour of AGL during the high spot prices in March 2008 is subject to investigation by the AER.

The following chart shows historical South Australian spot electricity and forward contract prices.

South Australian Spot Prices and Contract Prices



[1] Review of the Effectiveness of Competition in Electricity and Gas Retail Markets in South Australia, First Draft Report, 4 July 2008, AEMC, page 16.

This chart shows that Financial Year (FY) 2007/08 forward prices increased in June 2007 to around $90 per MWh. Contract prices remained high until March 2008 at which point they dropped to more normal levels of around $60 per MWh. Note that in the period June 2007 to March 2008 hedge contracts were available in the market. However the prices were significantly higher than those that customers were used to and higher than the allowance in retail price caps.

Spot prices experienced in March 2008 were the highest in any state since the market commenced 10 years ago. This arose due to a combination of the following events:

- Record demand following an unprecedented heat wave with 13 days in succession over 37 degrees Celsius. The demand levels were well above Origin 1% Probability of Exceedance demand forecasts;
- A down rating of the Heywood interconnector in December 2007 from 440 MW to 340 MW. This down rating was not expected or communicated to the market in advance; and
- AGL's recent purchase of Torrens Island Power Station. Origin is not in a position to comment on AGL's contract position. However, in general, we have observed that following an asset purchase it can take some time to realign contract positions to match generation and customer assets.

The graph on the previous page shows forward prices for FY 08/09 and beyond at around $60 per MWh. This means that the market sees the high prices in March 2008 as a one off event that is not likely to occur again in the next two years. Note that beyond FY 2009/10 uncertainty due to the impact of emissions trading is impacting adversely on price and liquidity. This is a much more significant issue for the market than recent price spikes.

Origin does not believe that recent high spot and contract prices in South Australia are sustainable nor are they likely to have a significant ongoing impact on retail competition.

<u>Gas Retailing in Regional Areas</u>

Origin notes that some retailers have identified that there are hindrances to gas retail competition in regional areas of South Australia however:

- these are short-term issues based on legacy contracts;
- it is a very small part of the total gas market; and
- the impact on regional customers is clearly mitigated by the behaviour of Origin as the incumbent retailer.

Firstly, as the AEMC draft report notes, Origin has a Memorandum of Understanding with the South Australian Government that Origin will provide access to any retailers seeking access and during this period, Origin was approached by a retailer and accordingly provided them access. This solution is not ideal for other stakeholders but Origin highlights that these contracts for transmission capacity in the affected areas will soon end and access will become available for competition will develop. Therefore this is a short-term issue which will be resolved by the market in due course.

Secondly, competition is generally effective in the South Australian gas market as the majority of customers (over 95%) are open to retailer choice without any limitations.

Finally, Origin has provided its standing offers and market offers for South Australia to ESCOSA and the AEMC which clearly identify that Origin is not varying its market offer behaviour between Adelaide and other regional gas customers. This consistent behaviour demonstrates that regional gas customers are not being disadvantaged at a time when their access to competition is restricted.

Origin therefore proposes that the AEMC's finding that competition is effective in the South Australian gas market is correct.

Price Regulation

The AEMC has rightly identified that competition is effective in South Australia and that on-going regulation of retail energy prices for small customers will be detrimental to competition.

It is important to reiterate that:

- price regulation has been at the expense of product innovation as the standing offer price has provided the benchmark for all retailers in the market, and in Origin's view, has had the effect of retailers converging their products on the standing contract price;
- price regulation has the potential to stifle competition in the market because it is unlikely that regulated tariffs will reflect a retailer's efficient costs of supply within a short period of time. As identified by the AEMC's analysis in their draft report, current regulated prices do not appear to provide expected retail margins because of the significant changes in wholesale energy costs. This will have the continued impact of reduced product offerings and retail participation in the energy markets.
- the requirement that regulated price determinations in South Australia apply for a minimum of three years substantially increases the risks over that the period that the price path will fall short of actual costs. Revisions to the three –year price path are allowed under only a limited range of circumstances.
- the negative impact of price regulation on future competition will also be exacerbated by the impact of the proposed CPRS and whether these costs are effectively passed through to retail customers. Origin questions the ability of regulators, however, thorough in their approach, to adequately capture these costs particularly given the form of the proposed CPRS (e.g where the generator is the liability point);
- Origin notes that several stakeholders have submitted to the AEMC that price regulation will ensure that energy prices are more efficient. This is incorrect and confuses keeping energy prices low, even below the cost of supply, rather than allowing energy prices to represent their efficient level;
- the long term interests of customers are not served by keeping prices below costs, as ultimately this flows back through investment decisions; and
- the vulnerability of small customers is a distinct issue that should remain separate from discussion of price.

Consequently, Origin would summarise that future retail profitability and market competition in South Australia will be dependent on whether price regulation continues. If it was to remain, particularly in its current format, then competition will be completely dependent on the regulator's capacity to forecast any and all cost changes that have and may occur within the energy market. This was always problematic. In the lead up to the CPRS, it is neither necessary, nor a tenable situation.

Should you require any further information in relation to this matter, please contact Patrick Whish-Wilson on (07) 3867 6020.

Yours sincerely

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