



12 July 2013

Mr John Pierce  
Chair  
Australian Energy Market Commission  
PO Box A2449  
Sydney South NSW 1235

Submitted online: [www.aemc.gov.au](http://www.aemc.gov.au)

Dear Mr Pierce

**ADVICE ON BEST PRACTICE RETAIL PRICE METHODOLOGY (EMO0027)**

Origin appreciates the opportunity to comment on the AEMC's Issues Paper with respect to best practice retail price regulation and has set out its comments in the attached submission.

Origin looks forward to continued participation in the current review. If you have any queries, please contact Keith Robertson on (02) 9503 5674.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Phil Moody".

Phil Moody  
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## 1. Executive Summary

In line with the commitment of the Council of Australian Governments<sup>1</sup> Origin supports the removal of price regulation where competition is effective, on the grounds that competition is a better means than regulation to discover efficient prices and promote customer interests. Price regulation is required in monopoly markets as a substitute for competitive forces, but in competitive markets is costly and unnecessary. Where regulation of prices remains it should be cost reflective and promote the development of further competition, with a view to deregulation. In the event that full price deregulation cannot be achieved in the short term for some jurisdictions then a light-handed propose/respond model similar to that in place for gas in New South Wales would be preferable to full regulation. There should be no change to the regulatory framework or pricing regulator for NSW or QLD given the status of the AEMC review of retail competition in NSW and recent announcement by QLD Government that it proposed removing retail electricity price controls in South East Queensland by 1 July 2015.

The AEMC's work in this area takes place in the context of increasing recognition among policy makers of the benefits to end customers of competition in energy services and growing momentum to deregulate retail energy prices. On June 17 the Queensland Government announced its intention to deregulate electricity prices by July 1 2015,<sup>2</sup> following similar decisions to deregulate in Victoria and South Australia. In its Final Decision on retail prices in New South Wales the Independent Pricing and Regulatory Tribunal found competition to be effective and that pricing regulation should be removed.<sup>3</sup> The draft decision of the AEMC on the effectiveness of competition found competition to be effective in gas and electricity.

Methodologies for regulating retail prices in each of the major NEM jurisdictions where Origin is active have generally been devised in light of a longstanding commitment by all state and territory jurisdictions<sup>4</sup> to deregulate retail energy prices where competition was effective. This commitment is pertinent to an investigation of different regulatory methodologies, since it implies approaches to price regulation that facilitate entry by second tier retailers and support greater rivalry between incumbents, promoting more cost reflective outcomes for consumers. For this reason, approaches should not differ depending on the level of competition in the jurisdiction in question, since this could inadvertently impede progress towards a competitive deregulated market.

In addition to supporting a path to greater retail competition, methodologies should promote consistency in approach. Frequent changes in methodology or price level are likely to dull incentives for market entry and for investment in marginal generation. Also, customers value predictability in price paths. This need for consistency is a general principle that applies except to the extent a chosen methodology is not cost reflective, in which case it should be returned to cost reflective levels as rapidly as is feasible, since each year this is delayed implies a larger price shock for customers.

Origin appreciates that this initial piece of work represents the AEMC's advice to Ministers at the level of objectives and high level working principles. As a result, further

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<sup>1</sup> The Council of Australian Governments, Australian Energy Market Agreement, (Amendment 2 June 2006) cl.14.11

<sup>2</sup> Hon. Mark McArdle, Queensland Minister for Energy and Water Supply "End electricity price regulation to improve competition", Media Statements, June 17

<sup>3</sup> Independent Pricing and Regulatory Tribunal "Final Report - Review of Regulated Retail Prices for Electricity - From 1 July 2013 to 30 June 2016", June 17

<sup>4</sup> The Council of Australian Governments, Australian Energy Market Agreement, (Amendment 2 June 2006) cl.14.11

consultation will be required before conclusions can be drawn in detail on best practice methodologies.

#### *Wholesale energy*

Origin supports a framework that recognises the on-going cost of generation based on estimates of long-run marginal cost. Approaches that attempt to reflect short-run marginal cost by tracking changes in primary and secondary markets for electricity and related derivatives require frequent revision, add to the regulatory burden, are more prone to error and lead to more volatile retail prices, none of which is in the interests of the end customer. Generation in the National Electricity Market relies on long term investments and the return of capital from these investments occurs over periods of several decades rather than several years.

Estimates of long-run marginal cost must effectively incorporate realistic assumptions about load shape, future fuel costs, site-specific capital costs and the weighted average cost of capital. They must also include an effective reserve margin that accounts for plant outages and the increased intermittency of renewable generation.

#### *Network costs*

Current arrangements for the release of distribution network prices do not leave adequate time for retailers to integrate network prices, particularly in light of jurisdictional requirements to publish retail prices in advance of when they apply. Final network prices frequently differ considerably from draft prices, reflecting a consistent upward bias. Retailers are frequently required to apply network prices in a matter of days. In addition to making it more difficult for customers to learn about price changes in a timely fashion, these arrangements limit scope for innovative network and retail tariffs, impede competition, and are likely to lead to higher retail prices over time than would otherwise be the case. Origin supports the rule change proposal (ERC0149) that seeks to address these shortcomings in the current framework.

Origin recognises that retail price regulation has the potential to complicate the introduction of time of use tariffs. Victoria has deregulated retail prices and is the only Australian jurisdiction where there has been a large-scale rollout of smart meter technology allowing for complex time of use pricing. As contemplated in the AEMC's Power of Choice review, market-led deployments of smart meter technology are likely to coincide with moving customers to market contracts. Where prices continue to be regulated the weighted average price cap allows for retailers to devise tariffs that incorporate time-of-use data. Given the level of competition in NEM jurisdictions there are incentives and effective mechanisms for retailers to move to more cost-reflective pricing in a measured way that does not generate price shock.

#### *Retail operating costs, margin and competition allowance*

Retail operating costs should reflect those of a large retailer subject to retail competition and so must include an allowance for the acquisition and retention of customers. Acquisition costs include both direct costs to acquire the customer along with indirect marketing costs including price discounts to attract customers. Productivity gains should be accounted for through the building block process rather than through exogenous productivity indexes.

Setting a retail margin is an inherently uncertain process and the methodologies should recognise this and prompt the regulator to adopt values towards the upper end of the estimate. The risk of inaccurately estimating retail margin is asymmetric in that a margin set below actual levels will harm competition, whereas margins set above efficient levels will typically be competed away.

*Form and timing of price controls*

The building block approach, combined with a weighted average price cap (WAPC), represent the most appropriate form of regulation in Origin's experience.

A pass through mechanism is an important tool when setting regulated prices in that it reduces the level of risk that must be factored in to retailers' prices. The pass through mechanism should allow for retailers to increase prices to recover lost revenue due to unidentified events and/or identified events of uncertain timing or magnitude. Pass through mechanisms should allow for pass throughs within period, since the alternative is likely to lead more volatile price changes.

## **2. Introduction**

In May 2013 the Australian Energy Markets Commission (AEMC) was tasked by the Standing Council and Energy and Resources (SCER) to provide advice on a best practice method for retail pricing. This followed SCER and the Council of Australian Governments (COAG) reaffirming their commitment to deregulate retail prices where competition was effective. In June the AEMC released an Issues Paper to canvass initial views on best practice price methodologies. Origin provides its response to the Issues Paper in this document. The AEMC must deliver its final response by the end of September 2013.

### **3. Approach, Objective and Principles**

Origin broadly supports the approach, scope and objectives of the AEMC as outlined in the Issues Paper, with some specific concerns dealt with below, most notably with respect to the AEMC's timelines for providing advice.

#### *Approach and scope*

Origin understands that opportunities for public consultation beyond this initial Issues Paper will be limited by time constraints. In light of this, Origin appreciates that this initial piece of work represents the AEMC's advice to Ministers at the level of objectives and high level working principles. As a result, further consultation will be required before conclusions can be drawn in detail on best practice methodologies. Origin supports the scope outlined, however we note that the SCER has not requested the AEMC to address gas and that regulation of gas prices remains in place in New South Wales, albeit under a more light-handed approach. Origin supports the continuation of this model with IPART as regulator until retail gas price regulation is removed in NSW.

The QLD Government recently announced that it proposed removing retail electricity price controls in South East Queensland by 1 July 2015 providing it can be demonstrated that customers can benefit, and adequate customer protections are in place. The AEMC's draft report recommended that electricity and gas retail price regulation should be removed in NSW; the AEMC's final report is due in September 2013. Given that both of these jurisdictions are also part way through a three year determination period Origin strongly recommends that the existing regulatory frameworks (including current approach to consult on methodology) remain in place in NSW and QLD through to the removal of price regulation. A change in framework and/or regulator at this point would incur unnecessary cost and lead to greater uncertainty that could harm the development of competition for limited gain.

#### *Propose/respond*

Price regulation is essential in monopoly markets where there is no competition, such as the distribution of electricity and gas. In markets that are competitive price regulation is costly and unnecessary. In the event that full price deregulation cannot be achieved in some jurisdictions in the short term then a light-handed, propose-respond model, similar to that in place for gas in NSW, would be preferable to full price regulation as a temporary measure. If this was to be adopted for electricity it would need to be provided for in the terms of reference for the relevant jurisdictional regulator. IPART called for this approach in electricity in its most recent determination, however this was less effective because the overall framework lacked clarity around how IPART would respond to the proposal and appeared to require IPART to follow the same detailed assessment process regardless of retailer proposals. Origin did not provide a proposal and EnergyAustralia's proposal was rejected as being above IPART's final cost estimate. The framework must provide an incentive for retailers to provide reasonable price estimates that can be assessed by a regulator without the current regulatory cost burden.

#### *Objectives and principles*

In relation to the objectives of price regulation Origin reiterates that all jurisdictions in Australia have recognised that regulation should not be applied where competition is sufficiently developed to promote customer interests, since effective competition is a more reliable means to promote efficient prices and superior customer outcomes. Furthermore, price regulation should seek to promote the development of competition,



including in jurisdictions that are in an early phase of development towards retail competition.

Comments relevant to each principle are included in Table 1, below. Origin proposes that an additional principle of promoting competition be added (fourth row below).

Principle	Comments
<i>Cost efficiency</i>	Prices should be cost efficient over the medium term and encourage competition. Attempts to track volatile movements in the wholesale market will not support greater competition and will increase unpredictability for end customers.
<i>Cost reflectivity</i>	Prices should be cost reflective. When prices fall below cost reflective levels this reduces scope for competition and leads to larger and more disruptive corrections.
<i>Transparency</i>	Transparency is valuable in prices and in the methodology. It is also useful in relation to any modelling work commissioned by regulators from consultants. In certain circumstances retailers may need to provide data on a confidential basis and the principle of transparency should not preclude this provided the overall methodology is transparent.
<i>Promote competition</i>	Prices should be set at a level which encourages competition in the retail electricity market.
<i>Open and consultative process</i>	Process should be open and consultative with adequate time to consider draft decisions. This involves establishing a clear timetable well in advance of the process, with opportunities to provide input at both the Issues Paper and the Draft Decision stage. Stakeholder workshops and direct consultation improve the quality of the final outcome. Introducing new issues for consultation midway through the process should be avoided.
<i>Predictability and Stability</i>	Consistency reduces the regulatory burden and improves confidence of industry and customers. As noted by the AEMC, this should not preclude changes to methodologies, particularly when approaches have ceased to fully reflect underlying cost, since delaying a correction implies more disruptive price changes for the end customer and delays the benefits of competition.
<i>Minimising the administrative burden</i>	Setting wholesale costs based on long term marginal cost is likely to lead to fewer adjustments and a lesser regulatory burden. Methodologies that support a rapid transition to full deregulation will minimise the regulatory burden relative to a situation with on-going pricing regulation.
<i>Appropriate allocation of risk</i>	Risks should be allocated to the party best placed to manage them. Retail prices must allow for the risks involved in operating a retail energy business in a competitive market.

#### 4. Wholesale energy costs

##### *Overall objective*

The methodology adopted to estimate the cost of wholesale energy should recover the efficient costs of a retailer and in so doing recognise that retailer wholesale costs generally reflect a portfolio approach, including own generation, long term power purchase agreements and the methodology should also allow for regulators to encourage greater competition.

### *Stand-alone long-run marginal cost the most reliable methodology*

Origin supports a framework that recognises the on-going cost of generation based on modelling of stand-alone long-run marginal cost. Approaches that attempt to reflect market-based costs by tracking changes in primary and secondary markets for electricity and related derivatives require frequent revision, add to the regulatory burden, are more prone to error and lead to more volatile retail prices, none of which is in the interests of the end customer. Market based approaches recently applied by regulators have excluded long term contract prices and so missed a large proportion of major retailers' cost base. Generation in the National Electricity Market relies on long term investments and the return of capital from these investments occurs over periods of several decades rather than several years. In practice retailers focus on securing adequate energy at predictable prices will necessarily be long term regardless of market movements and regulators' approaches.

A "stand alone" LRMCM based methodology is a more appropriate and accurate means of estimating the wholesale energy cost than an approach that seeks to integrate the cost of market-based derivatives because:

- it is a forward looking approach that better approximates the actual costs of retailers' purchases through PPAs and 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 modelled and identifiable; and
- it is far less volatile over time than a market based approach.

In circumstances where generation capacity is surplus to average demand some regulators have considered that moving to market-based cost is more cost reflective and therefore in customers' interests. In Origin's view this approach sends conflicting signals to investors in additional units of generation. This approach is not an accurate assumption about retailers' costs in Origin's view, since it assumes that in times of low wholesale prices retailers costs only reflect the cost of purchasing hedging contracts and do not include the cost of building or acquiring generators. Instead, retailers' costs reflect the cost of plant that they build to supply their customers, the costs of power purchase agreements they buy, spot purchases and hedging costs.

Where regulators have sought to reflect short term changes in market based purchase costs to deliver cost savings to customers they risk overlooking the impact of these approaches on overall regulatory risk in the market. Greater levels of regulatory risk have the potential to increase prices over the long term and to increase barriers to entry thereby decreasing levels of competitive activity.

### *Key Inputs to LRMCM Calculations*

Approaches to projecting load forecasts must ensure they adequately reflect the actual load shapes, and variability therein, retailers face. Also, there must be mechanisms to account for realistic assessments of future fuel costs consistent with the portfolio of generation being modelled. Allowances for volatility and prudential capital are appropriate, but not as substitutes for a robust estimation of costs based on long-run marginal cost.

Estimates of long-run marginal cost must effectively incorporate realistic assumptions about site-specific capital costs of new plants and the weighted average cost of capital. They must also assume an effective reserve margin that accounts for plant outages and the increased intermittency of renewable generation.

The long-run marginal cost approach has added benefits in that it:

- avoids the problem of liquidity constraints in the derivatives market which can mean that market-based prices are unreliable (this has been an issue in QLD, SA and NSW);
- avoids the impact of renewable energy generation which (with negligible marginal cost) puts downward pressure on Pool prices but does not reflect the system-wide costs of renewables;
- relies less on “black box” econometric modelling approaches that require assumptions about strategic bidding behaviour and lack transparency.

#### *Market-based approach*

For the reasons outlined above Origin believes an approach based on market prices and associated derivatives is inferior to an LRMC approach. However, if the AEMC was to determine that a market-based approach should be considered an option for regulators, then a number of factors determine the most appropriate version of this approach:

- long term contracts should be used as points of input, rather than exclusive use of short term contracts;
- actual market prices should be used in preference for modelled market prices;
- rolling averages of key indicators should be used rather than point-in-time indicators, since the latter are more prone to distortion.
- The “model” hedging strategy adopted must recognise retailers’ practice and market liquidity.
- Modelled spot price forecasts must be shown to reflect a reasonable range of outcomes with reference to historic outcomes, expected future trends and contract market prices.

## **5. Network costs**

#### *Timing of release of network prices*

As outlined in its submission to IPART’s rule change proposal on the release of network prices, Origin supports the rule change. Retailers do not currently have enough time to integrate network tariffs into retail prices, particularly in light of jurisdictional requirements for advance notice of retail prices. In NSW there is insufficient time for standard retailers to prepare regulated retail tariff proposals, for IPART to assess and approve these proposals and for retailers to then update their IT systems and communications material with approved tariffs. Applying network tariffs in a matter of days creates significant operational risk, and tends to lead to less cost-reflective prices, limiting the scope for innovative offerings. In some cases retailers are required to delay retail prices until after network prices have changed, increasing working capital requirements and putting upward pressure on prices.

Networks are best placed to manage the risk of variations in network forecasts, as they are privy to most relevant information and a large part of their expertise relates to long term forecasting of network requirements. When retailers manage the risk of variations in network forecasts this increases the aggregate level of risk. Retailers that seek to

integrate this risk into retail prices will set prices at inefficient levels, diminishing the benefits of competition for the end customer. The increase in retail prices and increase in the volatility of prices has a greater negative impact on customers than any increase in the regulated cost of capital that would be required by distributors to account for marginal variations in forecasts.

#### *The pass through of time-of-use network prices*

Origin recognises the complications that time-of-use pricing can introduce into the process of setting regulated retail prices. We note that a broad deployment of smart meters to small customers has only occurred in Victoria where prices have been deregulated. Any market-driven rollout of smart meter technology would be likely to be done in such a way that customers were moved to a market contract as part of the offer. Where prices continue to be regulated the weighted average price cap allows for retailers to devise tariffs that incorporate time-of-use data. Given the level of competition in NEM jurisdictions there are effective mechanisms both for retailers to move to more cost-reflective pricing and to move in a measured way that does not generate price shock and encourage customers to move.

## **6. Retail operating costs and retail margin**

Origin supports methodologies that recognise retail costs, provide adequate retailer margin and create more favourable conditions for new entrant retailers, with a view to encouraging effective competition and full price deregulation.

#### *Retail operating costs*

Origin supports a definition of standard retailer being a large retailer with economies of scale subject to retail competition, provided this does not preclude allowances being set at a level that encourages competition from new entrant retailers.

Determining efficient retail operating costs should be based primarily on retail submissions. Costs should be escalated broadly according to CPI but the methodology should allow for the regulator to take into account specific drivers of retailer costs that have typically grown faster than CPI, for example the costs of building and maintaining IT systems. Regulators should have scope to use benchmarking as a means to check the accuracy of bottom-up approaches.

Regulators should not be required to account specifically for gains in productivity over the forecast period, as this can be accounted for in a building block approach to setting revenues. Setting a productivity factor is more akin to index-based approaches to setting prices, which in Origin's experience have resulted in less accurate and cost-reflective retail pricing in the past. Furthermore, in NEM markets competition creates a further incentive to set prices at efficient levels.

Retail costs should recognise the cost of acquiring and retaining customers, since this is a cost all retailers face in markets with competition. Acquisition costs include both direct costs to acquire the customer along with indirect marketing costs including price discounts to attract customers.

### *Retail margin*

Estimating and setting retail margins is a highly complex process. In its decision on prices for the period 2013 to 2016 IPART adopted all three mechanisms identified by the AEMC in its Issues Paper and the results showed significant variation. Both the QCA and ESCOSA relied on findings from other jurisdictions. In Origin's view these outcomes highlight the difficulty in estimating and setting an appropriate retail margin in an industry where margins change due to a range of volatile factors and large vertically-integrated businesses work across numerous jurisdictions.

In light of this complexity regulators should be able to apply a range of methodologies, but in recognition of the uncertainty inherent in these approaches should be permitted to account for this, specifically by adopting estimates that sit towards the higher end of the range of values identified. The risk of inaccurately estimating the margin is asymmetric, in that a margin set too low will harm competition and negatively affect incentives for investment and market entry, whereas margins that are above efficient levels are likely to be competed away in NEM markets where competition is effective.

Origin believes margins should be applied on a percentage basis and to total costs - including network costs, as retailers must pay networks within stipulated terms or face immediate financial recourse. In contrast, a significant portion of customers do not meet payment terms and Origin must pursue these within regulatory constraints.

### *Competition allowance*

Origin supports a methodology that requires an appropriate margin in final prices to encourage greater competition. In practice a new-entrant retailer may face slightly higher costs to acquire and retain customers and the regulated allowance should reflect this if competition is to be encouraged.

While Origin supported IPART's final outcome in its recent determination on retail prices, we noted that in determining that the LRMC allowance was above cost and therefore represented additional "headroom" IPART was implicitly assuming that the cost of energy for vertically-integrated retailers was the marked-based cost. This ignores the fact that retailers source energy under a variety of arrangements, including own generation and long term PPAs. Origin concurs that a transparent assessment of the costs of acquiring and maintaining customers is in most cases the best way to improve conditions for competition.

## **7. Environmental and jurisdictional schemes**

The appropriate method to account for the Large-scale Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES) and jurisdictional schemes will depend on a number of factors including liquidity in the market for permits and the direction of Government policy. The approach should be cost-reflective and a pass through mechanism allows for retailers to recoup unrecovered revenue due to changes in policy or unforeseen market movements.

LRET prices should be based on the long-run marginal cost of generation for the same reasons as outlined with respect to wholesale cost, while for SRES the allowance should be based on the clearing price of \$40, in recognition of the lack of transparency around

volumes traded in the secondary market and considerable volatility in this market due to policy uncertainty.

## **8. Form and timing of price controls**

The building block approach, combined with a weighted average price cap (WAPC), represent the most appropriate form of regulation in Origin's experience.

The building block approach has in Origin's experience proven a more accurate means to estimating efficient price levels than other approaches. Index approaches are less flexible. Increasing all prices by the same index figure introduces a high level of path dependence which is more prone to error over time.

While under the WAPC the retailer carries volume risk, it is also able to adjust price in markets moving towards effective competition or where competition is already effective. Compared to a revenue cap the WAPC control promotes more efficient tariff formation, better aligns revenue with levels of demand and reduces volatility in prices when demand diverges from forecast levels. Revenue caps do not have strong incentives to provide economically efficient volumes, since retailers' revenues are fixed, instead the incentive is to minimise costs regardless of changes in volume. The retailer should be given scope to incorporate network elements as appropriate.

Setting individual tariff prices is not efficient in a market where competition is effective is expected to develop, which is all the NEM markets based on the commitments of jurisdictional governments.

### *Pass through mechanisms*

A pass through mechanism is an important tool when setting regulated prices in that it reduces the level of risk that must be factored in to retailers' prices. The pass through mechanism should allow for retailers to increase prices to recover lost revenue due to unidentified events and/or identified events of uncertain timing or magnitude. Pass through mechanisms should allow for pass throughs within period, since the alternative is likely to lead more volatile price changes.

There is no ideal length for a regulated price determination period, however timelines should take in to consideration jurisdictional intentions with respect to price deregulation.