origin

12 April 2010

Dr John Tamblyn
Chairperson
Australian Energy Markets Commission

Project # EPR0017
By e-mail: www.aemc.gov.au

Dear Dr Tamblyn

REVIEW OF THE EFFECTIVENESS OF COMPETITION IN THE ELECTRICITY MARKET IN THE ACT

Origin Energy Retail Limited (Origin) welcomes this opportunity to comment on the Australian Energy Market Commission's (the Commission's) issues paper on the review of the effectiveness of competition in the electricity market in the Australian Capital Territory (ACT).

Origin supports the process the Commission engages in to assess the effectiveness of energy market competition that may lead to a recommendation to remove or retain price regulation. We note that retail price regulation is currently being assessed by the ACT Government, in parallel with the Commission's review, but with a focus on improving customer choice. We agree that the focus of the Commission's work should be on the effectiveness of competition.

In Origin's view, price controls have been a factor in delaying the development of effective competition in the ACT. When regulated prices are not set at market levels competitive activity will be constrained. Thus customers will not enjoy the many benefits of competition in the ACT until regulated prices are set at levels that allow competition to develop.

The Independent Competition and Regulatory Commission (ICRC) recognised this regulatory barrier to the development of competition in 2009 (as noted by the Commission on page 11 of the issues paper). Origin acknowledges that the ICRC is also considering customer acquisition costs in its review of retail prices for 2010-12.[1]

New entrant costs are not merely the cost of acquiring a customer through marketing activity, but also include the establishment costs associated with the regulatory and legislative environment in the relevant market and the degree to which this is harmonised with other jurisdictions. If regulated retail prices do not reflect the marginal cost of customer acquisition in this respect, they are likely to have detrimental effect on competitiveness and consumer choice.

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[1] ICRC (2010), *Issues Paper – Retail prices for non-contestable electricity customers 2010-12*, page 11. See: http://www.icrc.act.gov.au/__data/assets/pdf_file/0011/183647/Report_2_of_2010_1_March_2010.pdf

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While Origin recognises that the AEMC's review examines historic outcomes and will therefore reflect the limitation of previous regulatory decisions, we acknowledge that the ICRC is currently examining the inclusion of new entrant costs (such as customer acquisition costs).

The introduction of the Carbon Pollution Reduction Scheme (CPRS) – or similar arrangement - exacerbates the risk associated with price regulation as it makes it even more difficult for the government to predict the market price. This can also damage the viability of the electricity market as new generation development relies on all parties in the energy chain operating in normal commercial environments where they can implement strategies to suitably manage their risk.

Origin notes that ActewAGL Distribution has installed manually read interval ("type 5") meters on a new and replacement basis since 2007.[2] Advanced metering infrastructure will amplify the risk of error in setting regulated prices, since interval measurement of small customer consumption unwinds cross subsidies that exist among small customers, with differential impacts on customers and more complex retail and network price offerings.

In our view, maintaining uniform price ceilings in markets where large volumes of interval data are used for settlement will curtail the efficiency of the National Electricity Market.

In general, Origin believes that the structure of the ACT electricity market in principle supports competitive outcomes, although its limited size means that every effort should be made to harmonise the regulatory framework with other jurisdictions and/or the national framework, as this emerges.

Regulated prices that are set too low can significantly weaken competition. It is possible that the relevant legislation restricts the regulator from setting regulated prices at an appropriate level.

To illustrate this, Origin notes that the regulator has not historically interpreted section 20(2)(d) and (e) of its governing legislation (Independent Competition and Regulatory Commission Act 1997) to extend to making determinations that include new entrant acquisition and marketing costs as elements of:

- an appropriate return on investment [clause 20(2)(d)]; and
- part of the cost base of a regulated industry [clause 20(2)(e)].

We note, however, that the regulator has sought direction from the ACT government on this issue (as discussed above) and is considering these costs in its current review of regulated retail prices. We believe that the long term interests of customers will be best served through price levels that facilitate greater competition. This may require legislative change.

[2] *ActewAGL Distribution response to the MCE 's Smart Metering Phase 2 Report – Cost Benefit Analysis of Smart Metering and Direct Load control*, page 6. See: http://www.ret.gov.au/Documents/mce/_documents/Actew_AGL_Distribution20080417104909.pdf

Origin responds to selected issues raised in the issues paper below. We would welcome further discussion with the Commission on any of the comments made in this submission. If you have any questions in relation to this response, please contact myself on (03) 9652 5702.

Yours sincerely

[redacted]

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Market Definition

1. What characteristics of the ACT electricity retail market should the AEMC take into consideration when defining the market for this review?

Origin does not believe the characteristics of the ACT market differ greatly from any other retail electricity market within the NEM. In many respects, small electricity customers (and their market) in the ACT are indistinguishable from those in New South Wales (or elsewhere). The AEMC should focus on retail market competition. Production and wholesale markets are currently effective in the NEM.

Market Structure

2. Have the structural conditions for electricity retailing in the ACT supported or hindered the development of effective competition? Are these structures likely to support or impede further improvements in competition in the future?

The size of the ACT electricity market necessarily means that new entrants must recover any costs of establishing themselves in the market over a small number of customers. Two significant categories of new entry costs include marketing (including acquisition) costs and regulatory compliance costs. These costs and the relationship with the structure of the ACT electricity market are discussed below.

Marketing and acquisition costs

The incumbent retailer offers multiple utility services and has strong brand recognition. Any new entrant will have to devote significant marketing resources in order to build market share in the ACT as a result. These costs need to be recovered across a smaller customer base in the ACT. The same principle applies to fixed customer acquisition costs (through telesales or door-to-door sales) and the need to recover these costs over a relatively small market share.

Regulatory compliance

A new entrant will face costs to establish systems and processes to comply with licence and regulatory obligations in any jurisdictions it intends to enter. Given that there remains a lack of harmonisation between Australian jurisdictions, these costs are likely to be significant in a jurisdiction as small as the ACT.

In the absence of the National Energy Consumer Framework (and its adoption by most or all jurisdictions) and greater level of consistency across various states and territories, barriers to entry will be higher in all jurisdictions, and particularly in jurisdictions with small markets.

3. Are there barriers to entry that impact on the development of effective competition? Have these barriers dissuaded prospective electricity retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
4. Are there barriers to expansion or exit that impact on the development of effective competition? Have these barriers dissuaded prospective electricity retailers from entering or can they be overcome? Are these barriers likely to persist or abate?
5. Are there unique or specific features of the ACT electricity retailing environment that may support or impede the development of competition? For example, retailers offering multi utility and dual fuel products?

As discussed above, some of the barriers deterring entry include marketing to establish brand identity given the strength of the incumbent's business model and the cost imposed on retailers of building systems and process to cater for different regulatory regimes. Price regulation has not historically recognised these costs.

Barriers to expansion may be imposed by the imposition of new regulation (or complex changes to existing regulation, for example, the feed-in tariff scheme), or significant changes to the regulated price level from year to year (where the change fails to account for costs, including wholesale market costs) faced by new entrants.

The general uncertainty created over the last few years regarding the policy towards an approach to price (de)regulation in the ACT may have affected potential new entrants' view of the risks and costs of investing in retailing within the ACT.

Origin does not believe there are significant barriers to exit for new entrant retailers.

The multi-utility offerings of the incumbent retailer present a challenge to new entrants in the ACT electricity market. What is critical however is the strength of ring-fencing that applies to the incumbent's retail and monopoly business units. If ring-fencing is perceived to be weak, it diminishes confidence in the market and will deter entrants on the basis that the market may not be competitively neutral.

Market Conduct

6. What does the current level of rivalry between retailers indicate about electricity retailing in the ACT?

The easing of competitive outcomes identified by the Commission on page 13-14 of the issues paper was in our view largely a reflection of uncertainty of the price regulation framework in the ACT and the difficulties of optimising regulatory decision making in an environment of input cost volatility for retailers (especially wholesale costs).

7. Has retail price regulation encouraged or impeded tariff innovation, product differentiation and service competition?

Origin does not provide specific evidence in response to this question; however it is difficult to see how price regulation has encouraged innovative tariff structures, differentiation and competition on the basis of greater service. The range of offers and differentiated products available to customers where regulatory price oversight is no longer in place (Victoria) is greater than in the ACT (this is still likely to be the case when controlling for the size of each market). To consider question 7 above as a counterfactual, Origin is not aware of evidence that demonstrates that price regulation in the ACT has encouraged investment in product innovation and differentiation by new entrant retailers.

8. On what basis, and to what extent, might retailers be expected to compete in the future?

New entry will remain constrained by the costs of entry and price regulation. Uncertainty about the future policy direction of price regulation will exacerbate this.

Origin would not expect significant changes to the level of competitive activity in the ACT are likely to occur in the short to medium term as long as these constraints and uncertainties remain. However, a vigorous commitment by the regulator to a consistent and stable regulatory environment that is harmonised with the national framework may alter that perception.

11. What effect, if any, does retailer exposure to fluctuations in wholesale electricity prices have on retailers' ability to offer competitive product and service offerings?

Wholesale market fluctuations are difficult to manage where price regulation remains in place. Retailers are exposed to the uncertainty of regulatory decision making. So while a new entrant may decide to enter the market based on an acceptable regulated price level, their continued presence or growth in the market may be significantly affected if regulated prices fail to reflect wholesale market volatility.

Market performance

15. Are retailers able to recover their efficient costs at current standing and market offer contract tariffs? Are future expected profit margins likely to be sufficient to encourage new entry and increase competition or will new entry be deterred?

Retail price regulation in the ACT does not make an allowance for the acquisition costs of retailers (discussed above). The ICRC addressed this issue in 2009, concluding that an allowance should not be made for acquisition (or customer retention) costs. However, the ICRC also said in its determination of TFT for 2009-10 that:

> Whether or not an allowance should be granted for customer acquisition costs also raises the issue of the role of a regulated price in a market that has been declared competitive by the government.[3]

The ICRC seems to acknowledge that there is a fundamental conflict between the operation of a competitive retail market and the retention of price regulation. Origin agrees (where competition is considered effective, or *would* be effective if the source of market inefficiency was found to be the establishment of regulatory price ceilings below efficient levels). As we stated in our response to the ICRC's Draft Decision on retail prices for 2009-10:

> Origin has had considerable experience with the costs and risks facing a retailer entering a new market and in managing the subsequent business processes associated with customer churn and competition generally. If these costs are not recognised…by the pricing regulator when setting prices, then it is hardly surprising if competition fails to either occur or be sustained.[4]

We believe the continued regulation of retail prices discourages new entry and is detrimental to the long term effectiveness of competition in the ACT electricity market.

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[3] ICRC (2009), *Final Decision—Retail prices for non-contestable electricity customers 2009-10*, page 42. See: http://www.icrc.act.gov.au/__data/assets/pdf_file/0005/152636/Report_3_of_2009_5_Jun_2009_Web.pdf

[4] Origin (2009), *Draft Decision: Retail Prices for Non-contestable electricity customers 2009-10*, page 3. See: http://www.icrc.act.gov.au/__data/assets/pdf_file/0012/150024/Submission10_8_May_2009_Origin_Energy.pdf