4 July 2013

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

Submitted online: www.aemc.gov.au

Dear Mr Pierce

RULE CHANGE PROPOSAL ERC0149

Origin Energy (Origin) appreciates the opportunity to provide a response to the Australian Energy Market Commission's (AEMC) Consultation Paper with respect to the Rule Change Proposal (ERC0149) submitted by the Independent Pricing and Regulatory Tribunal (IPART), covering distributor price increases.

As outlined in its submission to IPART on this issue (a submission subsequently included as part of the IPART's proposal), Origin supports IPART's rule change proposal. Origin finds the current rules are inefficient and do not support the National Electricity Objective.

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.

In this way, current arrangements do not promote efficient investment, operation of, or use of electricity services with respect to price, relative to an alternative whereby retailers had greater notice of changes in prices.

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Is the assessment framework presented in this consultation paper appropriate for assessing this rule change request?

Origin agrees with the assessment framework presented in this consultation paper.

Are there any other key dates or inputs in the pricing process for TNSPs and DNSPs?

Origin is unaware of other key dates or inputs.

Other than the question of timing, are there any other differences in the regulatory arrangements in Victoria which are relevant for the purposes of this rule change request?

Origin is unaware of other differences in the regulatory arrangements in Victoria which are relevant for the purposes of this rule change.

What are the risks in requiring TNSPs and in particular, DNSPs to publish their annual prices earlier than currently required? What are the consequences of these risks and can these risks be adequately managed if the proposed rule is made?

Origin believes that the rule change proposed by IPART would reduce revenue risks associated with estimation relative to the status quo, and as a result would serve the National Electricity Objective, with respect to the efficient operation of energy markets, efficient investment and efficient pricing. Risk in the industry overall would be reduced and any residual risks could be managed.

The Consultation Paper outlines a series of factors that can lead to a divergence between the 'x factor' approved by the Australian Energy Regulator and actual distribution price outcomes:

- Changes in transmission price paths;
- Adjustments due to under or over recovery of distribution revenue caps;
- Cost pass through and contingency payments;
- March CPI figures;
- Loss factors as advised by AEMO;
- Jurisdictional scheme costs;
- Other factors within the price or revenue control formula, such as S factor and F factor schemes or efficiency benefit sharing schemes.

Under current arrangements the retailer is not guaranteed a reliable view of any of these factors before early June at the earliest, with the exception of CPI figures. This frequently does not allow adequate time for retailers to:

- formulate tariffs,
- implement these changes in billing systems; and
- publish these according to regulatory requirements (including within the various regulatory comparators).

As a result, a retailer must frequently rely on the x factor, CPI figure and the draft pricing proposal in order to produce a draft set of retail price, before adjusting these in a matter of one or two days once final network prices are available. Relying on draft prices is problematic with so many other factors at play, since the scope for divergence is significant.

When considering the drivers of changes between draft and final prices, it is important to draw a distinction between changes that occur due to:

- Updated distributor forecasts of variables such as consumption, transmission prices, uptake of rooftop solar, etc due to the elapsing of several weeks;
- The final process of negotiation between the distributor and the AER over final revenues and the suitability of key inputs to the pricing formula.

In Origin's view changes of the first type are rare, because the quality of forecasts for the coming year improve only marginally (if at all) between the draft in May and the final in June. By contrast, changes of the second type have been considerable and have created problems for retailers. For example, in 2011-12 ETSA Utilities[1] had an x factor in 2011-12 of around 9 percent that was reflected in their draft proposal, but eventual price rises in excess of 20 percent. In that case the divergence between draft and final did not arise because the distributor had improved its forecasts from May to June, rather it occurred because the final phase of negotiation over revenues had not commenced until after the submission of draft prices. In this period distributors make known to the AER their final applications with respect to pass through amounts, jurisdictional schemes, 's' and 'f' factors and similar schemes, and even the recent outcomes of Tribunal reviews. It is this final phase of revenue-setting that must be finalised earlier to reduce industry's reliance on estimation.

In light of the above, Origin questions the AEMC's assertion that "If TNSPs and DNSPs are required to set network prices with less actual information, then the revenue risks associated with a greater reliance on estimations could increase."[2] Under current arrangements industry's reliance on estimation is not less than under IPART's proposal, the reliance on estimation is simply shifted down the supply chain from networks to retailers, even though retailers are less well-placed to manage this. As a result:

- Significant operational risk is created where retailers must apply network prices in an unreasonably short period of time, or
- Retailers must delay the application of new retail prices, creating a mismatch in the network and retail pricing periods, driving additional working capital requirements and increasing end cost to the customer.

As outlined in IPART's proposal, this reliance on estimates also constrains the scope for retailers to build tariffs that are cost reflective and innovative, thereby reducing the efficiency of the regulatory process overall.

Under IPART's proposal both DNSPs and retailers would have visibility over all key inputs as of April, save for a subset of factors that may change moderately in the period between early April and June due to revised forecasting, which can be picked up in the subsequent year through the 'unders and overs' account.

Origin notes that there is some increased forecasting risk posed by a requirement to finalise distribution pricing proposals additional weeks in advance of the new financial year. However, in most cases updates are unlikely to be significant as a result of eight weeks having elapsed. A core feature of network expertise is the ability to forecast changes in network-related inputs over periods of up to five years. An extra eight weeks will add little to the accuracy of forecasts for the coming year. Weather, as one example, is a key driver of network requirements where the ability to forecast over a twelve month period does not improve two months closer to the forecast period. Equally, for the majority of inputs that are less volatile such as consumption volumes, new connections and macro inputs, the accuracy of forecasts is rarely likely to improve significantly over the course of two months. Solar bonus schemes are now closed and SRES multipliers reduced, which reduces uncertainty surrounding PV load growth. The

[1] Now SA Power Networks
[2] AEMC Consultation Paper, p.14

question of transmission prices is dealt with by IPART's proposal in all but the first year. Residual forecasting risk arising in the period April to June can be accounted for through true-up arrangements in subsequent years.

In Origin's view the net effect of releasing final distribution prices further in advance of when they apply would be to increase visibility of changes in prices across the industry, resulting in a reduction in risk and volatility in end prices and an increase in efficiency.

Should the AER have a set timeframe in which to assess all DNSP annual pricing proposals?
Is anything else involved in the AER approving a DNSP's annual pricing proposal?
How much time should be allocated to the AER for this assessment/approval?

Origin supports IPART's proposal whereby the AER would have a set timeframe in which to assess all DNSP pricing proposals, and considers that a timeframe of 20 business days is adequate. In the absence of this requirement there can be no certainty about when price proposals will be available. The AER faces time limits in many facets of its revenue setting process for distributors that limit its capacity to make time-consuming investigations. The final stage of pricing approval involves applying the pricing formula, rather than detailed bottom-up assessments. Jurisdictional regulators approve pricing proposals in much shorter periods of time, with comparable numbers of individual tariffs. IPART reviewed the retail tariffs relevant to the Essential and Endeavour areas in four days. Equally, allowing ten business days for distributors to re-submit seems more than ample. The final approval process might also be simplified by AER instituting more prescriptive requirements for the price trends documents, something also proposed by IPART.

While under IPART's proposal the AER would have reduced discretion to undertake detailed assessments of pricing proposals, there would be an offsetting benefit in terms of increased certainty for industry players and more cost reflective pricing. This will be a net benefit in our view.

How much time do retailers and jurisdictional regulators require for notification of network prices before finalising retail tariffs and notifying customers?
Is the proposed notification of two months sufficient?

Origin supports IPART's proposal of two months, which we believe is adequate for notification of network prices before finalising retail tariffs. This takes into account not only the time taken to incorporate the tariffs but also regulatory notification requirements for retail that can extend up to a month in some jurisdictions.

What type of consultation on level and structure of network prices would be useful to consumers/consumer groups and what benefit would there be?
How much scope would there be for consultation on proposed annual network prices?

Origin believes the market would be more efficient if networks consulted with retailers on the proposed level and structure of network prices. Retailers would better understand how the pricing structures could be applied and networks would better understand limitations in retailers' capacity to apply certain structures. This would lead to more cost reflective pricing and create greater opportunities for innovative pricing structures. There is no value in cost reflective network price structures if retailers are unable to reflect these in a meaningful way. Increasingly networks will need to get a sense of which tariffs will be reflected most closely in retail prices as this will have an impact on consumption.

Given time constraints implied by an earlier notification of final prices, consultation could be ameliorated by requiring distributors to begin consultation on price structures ahead of when the final prices apply.

How useful is the current statement of expected price trends to retailers and consumers?

What influences the statement of expected price trends?

Should a DNSP's approval of its annual prices be linked to how accurately it can track the statement?

As noted by the AEMC, the usefulness of the current statement of expected price trends varies by distributor. The statements would be more useful if they provided better and more accurate information and this could be achieved by having more prescriptive requirements. However, in all cases the usefulness of the documents is limited to the extent that they do not include reference to all the factors that create a divergence between price paths approved in access arrangements and actual network tariff outcomes. While nothing precludes distributors from sharing information about forthcoming adjustments to price paths, experience suggests this will not occur reliably in all cases.

Origin appreciates that there are factors in the pricing formulae which can be difficult for distributors to predict in advance, meaning it would be difficult for distributors to ensure that the price trends document was always a reliable indicator of price outcomes. However, the current shortcomings of the pricing trends document would become less significant if retailers had more notice of the factors driving divergence from approved price paths. Ensuring retailers have notice of these elements could be achieved either by a requirement for distributors to update price trends documents every time a significant change in inputs to upcoming pricing proposals became likely (a disclosure regime that would be difficult to enforce), or more simply by adopting IPART's core proposal – that retailers have two months to review final prices ahead of when they are applied.

What are the key dates in the initial year pricing process of TNSPs and DNSPs?

What is the best option to manage the first year pricing issue? Is it necessary to keep timings for the first year and subsequent years the same?

Origin agrees with IPART that the first year is of concern. It can be a greater concern since changes are often larger in the first year than in subsequent years. One possible way to address this would be for the NER to require a section in the Access Arrangement that addresses variance between revenues in the last year of the prior period and the price increase in the first year of the next period. This would then reflect the Distributor's best estimate of all factors that it believed would deliver a change to average price outcomes, in addition to the x factor. This could then be finalised at the same time as the Access Arrangement, rather than at the time of approving prices. Additional changes would then be limited in scope.

Proportionality

In Origin's view IPART's proposed rule change is proportionate to the problem identified. Retailers that receive inadequate notice of network prices currently either factor this pricing risk into retail prices in advance or subsequently adjust prices after network prices to account for any mismatch. This constrains the capacity of market forces to deliver the most efficient price.

Network pricing risk applies to all retailers in the NEM across each distribution area where those retailers are active. In the National Electricity Market there are 22 retailers active and 10 distribution areas relevant to retail competition. Each distributor has a variety of tariffs and the divergence from approved revenues does not follow any reliable pattern (except to the extent it has an upward bias), so when setting each retail tariff retailers are allowing for inadequate time to review network prices. The resulting margin for error is reflected in thousands of retail tariffs across the NEM.

Final network price increases have at times been multiples of the draft increases, implying that accounting for this risk requires more than a negligible margin of error. As a result, the problem of inadequate time for review affects all retailers and virtually all electricity customers in the NEM, in an on-going manner. Requiring distributors to move the finalisation of prices forward and account for any marginal changes in forecasts that arise as a result through their unders and overs account seems reasonable, given the proportions of the problem described.

If you have any questions in relation to the above questions, please contact me on (02) 9503 5674.

Yours sincerely,

Keith Robertson
Manager - Retail Regulatory Policy