12 May 2011

Mr Rod Sims
Chairman
Independent Pricing and Regulatory Tribunal
PO Box Q290
QVB Post Office NSW 1230

BY EMAIL ipart@ipart.nsw.gov.au

Dear Mr Sims

Changes in regulated electricity retail prices from 1 July 2011

Origin Energy (Origin) welcomes this opportunity to comment on *Changes in regulated electricity retail prices from 1 July 2011: Electricity – Draft Report* (draft report) prepared by the Independent Pricing and Regulatory Tribunal (IPART).

It is also important to note that Origin has increased its participation in the New South Wales energy market through the recent restructure and privatisation of the energy sector and purchase of the customers of Integral Energy and Country Energy. Accordingly, Origin has also addressed issues concerning the Cost-Pass Through applications of these respective businesses.

Origin acknowledges the difficulty associated with the setting of regulated prices for IPART (and other regulators) when retail prices for electricity have been on an upward trend for the past 5 years. Price increases have been experienced under the background of uncertainty around carbon policy and initiatives and renewed vigour toward the growth of investment into network distribution systems. Of particular note is the impact these price increases will have on customers and financial hardship.

Origin believes IPART has taken account of the issues that contribute to higher electricity prices and have made some important recommendations in this regard. Whilst not trying to detract from the importance of customer impacts, it is noted that the retail component of the cost increases is a minor driver within the supply chain accounting for only 1 per cent of the overall average 18 per cent price increase in the draft report.

Despite these difficulties, Origin believes IPART has undertaken a thorough review of the regulated prices as mandated in its terms of reference and has adequately adhered to its annual review process. Origin considers IPART has met its objectives in most respects and in particular supports:

- the input assumptions utilised by Frontier Economics for calculating the energy purchase cost allowance for the annual review in preference to that produced for the Australian Energy Market Operator (AEMO) for the 2011 National Transmission Network Development Plan. However as submitted to the QCA, Origin believes the most recent available market data is the most reliable for the energy purchase cost allowance. In that regard, Origin notes that the ACIL Tasman produced energy market modelling data for AEMO on 13 September 2010[1] appears to be the most up to date and relevant supply input assumptions for generation costs, and

- the process undertaken by IPART to establish an appropriate cost allowance for compliance with the Small-scale Renewable Energy Scheme (SRES) for both the cost-pass through application and the ongoing cost commitments of retailers.

Nevertheless, there are a number of issues that must be resolved before the final report is published to accurately mirror the true costs of retailers, and ensure adequate energy market investment decisions in the future. Specifically, Origin has concerns with the calculations undertaken by Frontier Economics to establish the cost pass through amount for the Large Scale Renewable Energy Target (LRET) and the annual review of the green energy cost allowance for the Greenhouse Gas Abatement Scheme (GGAS).

In addition to the issues raised in the draft report, the Federal Government has announced on 5 May 2011 changes to the solar credit arrangements for SRES. In the draft report, IPART has quite correctly used the estimates published by the Office of the Renewable Energy Regulator (ORER) to forecast the cost of SRES in 2012. These changes to the scheme will impact on the costs for the SRES in 2012; however Origin proposes that IPART take a pragmatic approach in its final report to address the impact this announcement will have upon the continued uptake of solar installations and the associated scheme costs. In this respect, Origin has made some suggestions as to the preferred approach to these changes within the final report.

These issues together with other comments are addressed in this submission and separated for clarity into issues affecting the Annual Review, the Cost Pass-Through Application and the Terms of Reference.

Annual Review

Origin acknowledges the decision to utilise the ACIL Report 2009 updated data used by the QCA in its recent draft decision[2] in preference to the information provided by AEMO as part of its 2011 National Transmission Network Development Plan (NTNDP). Origin notes submissions to the QCA in response to the draft decision took the view the most recent input data is the ACIL Tasman produced energy market modelling data for AEMO in 2010. In view of this, Origin requests IPART consider this data as an alternative to the updated 2009 ACIL Report.

Origin supports the current wording of the Terms of Reference[3] for calculating the energy purchase cost allowance. More specifically, Origin believes the Long Run Marginal Cost (LRMC) of generating plant must at least be the base level for energy costs rather than relying on a more volatile market based approach. The LRMC provides for certainty of the energy cost allowance, particularly where the market is subject to uncertainty such as with current carbon price policy and its expected impacts upon market volatility and liquidity in wholesale market contracts. In a price setting environment, the LRMC of generating plant as the floor for the energy purchase cost allowance supports price certainty of retailers from year to year within the limits of the price setting mechanism.

[1] Published report is available on AEMO website, www.aemo.gov.au/planning/scenarios.html, "Preparation of energy market modelling data for the Energy White Paper, Supply assumptions report, 13 September 2010.
[2] Draft Decision, QCA, BRCI 2011-12, December 2010
[3] Terms of Reference – regulated electricity retail tariffs and charges for small customers 2010-2013, available on IPART's website.

If the price setting process was to take a value below the LRMC of electricity generation this would have implications upon new investment in generation capacity as retailers will be unwilling to enter into long term power purchase agreements for the purposes of underwriting the generation investment. Retail competition will be impaired, investment decisions deferred, and potentially suspend new entrant decisions to enter the market or alternatively persuade participants to exit the market. The recent conclusions of the Australian Energy Market Commission (AEMC) in its review of retail competition in Australian Capital Territory provide support for this view.

Renewable Energy Target

The restructured RET scheme that commenced on 1 January 2011 has provided a new market scheme structure that effectively split RET into two separate schemes:

- the Large-scale Renewable Energy Target (LRET); and
- Small-scale Renewable Energy Scheme (SRES).

To fulfil the RET obligations, retailers are obliged to surrender certificates for both markets. The introduction of the restructured scheme must be reflected in the regulated prices for 2011-12 (including the cost pass through for 2010-11) and the new markets recognised in this equation. Origin supports the allowance based on estimates of efficient costs incurred in meeting the schemes as provided for in the Terms of Reference. Frontier has used a cost based approach to establish the estimate of LGCs and STCs, based on the LRMC of meeting the overall national target for the relevant year. Origin accepts this approach for establishing the costs of both schemes going forward.

Small-scale Renewable Energy Scheme changes

On 5 May 2011, the Federal Government announced adjustments to the Solar Credits arrangements that will have an impact on the strong demand for solar panels. As a result of the announcement, the Federal Government expects the costs for 2012 SRES to be reduced, however, the ultimate impacts are not predictable and the response of consumers to these changes is not easily forecast.

Origin notes that in its draft report, IPART sought responses about the best way to manage risk arising from STP forecast errors in the future. The recent changes to solar credits are an example of the risk that IPART has sought to address. In most instances, Origin believes the annual review and the cost pass through applications will provide adequate mechanisms to mitigate retailer risks. However, in this instance due to the timing of the announcement and its proximity to the IPART final report, Origin believes a pragmatic approach to resolving this particular risk is necessary.

Origin considers ORER is best placed to predict the impact the new changes will have upon the STP for 2012 and 2013. However, it is uncertain whether ORER will republish non-binding estimates following these scheme amendments. Therefore, in the absence of ORER publishing new non-binding estimates for 2012 prior to the publication of the final report, Origin supports IPART maintaining its current calculations for SRES costs based on the current ORER published estimates.

Origin would encourage IPART to explore a mechanism that if needed, will rebalance the actual SRES costs in the next Annual Review.

Greenhouse Gas Abatement Scheme

IPART has accepted the advice from Frontier Economics that the estimated LRMC of meeting the GGAS target is zero (the same as for the 2010 Final Determination). The rationale for the 2010 Determination was based on an existing surplus of NGACs in the market sufficient to meet the GGAS targets and the commencement of the Carbon Pollution Reduction Scheme (CPRS) bringing GGAS to an end. However, the commencement of CPRS was deferred having the effect of extinguishing the entire basis for which the zero allowance was supported. It is surprising Frontier has again cited the same reasons for the zero allowance when the same tenuous market circumstances exist around the carbon price introduction, and that the assumed forecast ongoing production of NGACs is more than enough to meet the GGAS target until its "assumed end date".

Frontier Economics has relied upon higher gas generation output to ensure an oversupply of certificates for compliance of GGAS, however this assumption is counter to the purpose of the recent change registration rules to reopen GGAS to new applications where existing accredited projects have changed ownership and the new owner is seeking accreditation for the purpose of the scheme. If there was an oversupply of NGACs the reopening of applications would seem a redundant exercise for both the scheme and applicants. Furthermore, recent movements in the market price saw increases from $5.00 to $7.50 which is not indicative of an excess in supply.

A zero allowance may be explainable in circumstances of a surplus at the end of a scheme, however the NGAC price showed an upward trend during 2011, and retailers have expressed the need to acquire further NGACs to meet future requirements while the scheme continues. Furthermore, given the uncertainties of carbon policy the scheme may continue for the foreseeable future.

Origin also point to the comments of Ernst & Young[4] that the scarcity of certificates at the end of the scheme will drive prices toward zero for surplus certificates or to the penalty price where there is a shortage of certificates. As there is no definitive end date[5] for GGAS to drive the NGAC price, Origin believes it is erroneous to imply surplus certificates as there is no certainty around the commencement of the carbon price at this time.

Origin submits the LRMC be calculated without the assumption of a carbon price as the market experiences in 2010-11 revealed there was a market for NGACs which was inconsistent with the consultant's assumptions. If the carbon price does not eventuate (similar to CPRS), the risk lies with retailers. As experienced with the recent Cost Pass Through applications, the CPRS deferral was not a trigger for a pass through event which leaves no recourse to retailer's for recovery of NGAC purchases in the event of a deferred carbon price.

Cost Pass through Applications

As provided by IPART in its draft report, there have been two changes to the Federal Government policy since the 2010 determination that could have resulted in the making of a cost pass through application. The amendments to the Renewable Energy Target

[4] Ernst & Young, Market Assessment of Green Cost Allowances – Cost Pass-through Application 2010/2011 – 2012/2013, January 2011

[5] IPART, Greenhouse Gas Reduction Scheme NEWSLETTER, 19 March 2011, "Current participants in GGAS would have anticipated that GGAS would end on 31 December 2012, but the timing will depend on the Commonwealth's progress in finalising arrangements to introduce a national carbon pricing mechanism.", page 1

Scheme (RET change) and the Government's announcement on 27 April 2010 that the implementation of CPRS was deferred. IPART has accepted the cost pass through event for the RET change but did not accept that the CPRS deferral amounted to an eligible event. Origin has made some comments regarding this consequence at the end of this submission.

In regard to the RET change, Origin believes the incremental cost allowance for LRET for 2010-11 period is significantly below the cost pass through applications for Integral and Country Energy and as such should be subject to further consideration. We note the cost pass through applications relied upon a market based approach and this is inconsistent with the LRMC approach utilised in the 2010 determination, however the underlying cost assumptions in calculating the LRMC have produced a final LGC price significantly lower than rational expectations.

Long Run Marginal Cost for LRET

Origin accepts the need to adopt the same methodology and assumptions (where appropriate) to establish the LRMC for LRET in order to determine the incremental cost from the 2010 Determination REC price. Therefore, in this instance, there may be a divergence between the LRMC for LGC and the current LGC market price. This being the case, holding constant certain assumptions can only be supported if the derived figure fits within the realm of expectation or there is a reasonable differential from the market price as this is likely to be closer to the actual price paid by retailers.

The basis for the change in policy objective for the RET scheme, the increased market price for LGC's since LRET was implemented, and the cost pass through applications of Country Energy, Energy Australia and Integral Energy all support a higher RET price based on large scale technologies. The details provided around the LRMC input assumptions by Frontier Economics are limited. However Frontier has made the assumption that only large-scale generators are eligible to create RECs to ensure the transformation from REC to LGC is appropriately reproduced.

Origin queries the data used by Frontier Economics to exclude the impact of the small scale technologies from the REC price and as such believes the 2005 BCSE[6] report has underestimated the true impact of small scale technologies, which has in turn skewed the resultant LGC price leading to an unrealistically low LGC price. Origin believes the removal of the small scale technologies from the eligibility of RECs should have more of a positive impact on price. Frontier acknowledged in its report that BCSE forecasts a substantially lower number of RECs created by small-scale generators in 2009 and 2010 which has resulted in a shift in demand for certificates which is bigger than the shift in supply of certificates. This has impacted the LRMC[7]. Frontier's conclusion is inconsistent with the dampening effect the small scale technologies had on the REC price and the basis for which the RET scheme was transformed.

Origin seeks further information about the cost assumptions and impact of data used in the BCSE report. Origin submits that the assumptions of the 2005 data are reviewed to enable the LRMC to better reflect the actual REC price paid by retailers. Additionally, Origin seeks further explanation of the large divergence between the estimated LRMC LGC price for 2010-11 ($35.71) calculated for the purposes of the LRET annual review and the estimated LRMC LGC price ($26.12) calculated to ascertain the incremental cost of RET. The market expectation would be for the two calculations to fall within a closer

[6] April 2011, Frontier Economics, Draft Report, Cost Pass Through Application page 13, 14
[7] April 2011, Frontier Economics, Draft Report, Incremental costs associated with LRET, p13.

range due to the overhang of banked RECs that are permitted to carry forward for use for the future LRET liability.

Other issues

Origin acknowledges and supports IPART's recommendations to improve electricity affordability. However, in relation to price setting, IPART seeks from the New South Wales Government more flexibility in establishing the energy purchase cost allowance in future determinations. Retailers and the energy market require certainty in pricing decisions to support retail competition and for proper investment decision making. Origin warns a flexible approach as advocated by IPART does not support principles of regulatory certainty and may have greater impacts on the energy market than IPART intends. Origin supports the form and purpose of the current Terms of Reference.

IPART has rejected the cost pass through application for incremental costs due to the deferral of the CPRS as made by Country Energy and Energy Australia. The rejection was based on the deferral failing to meet the definition of a regulatory change event.

The purpose of a cost pass through trigger is to enable retailers to recover any actual or likely incremental costs resulting from a regulatory change event. Origin believes the magnitude of the impact of modelling for a carbon price warrants reconsideration of the cost pass through definition to capture circumstances where major policy decisions of Government do not come to fruition and parties have incurred significant costs to meet the proposed policy objective. In 2010-11, IPART modelled for no CPRS in the energy cost component, but there were definite impacts upon other cost inputs, for example, the cost of NGACs that must be abandoned by retailers.

Consequently, Origin supports the possible expansion of the cost pass through event definition, or removal of the definition to enable retailers to fully recover unexpected or unaccounted for costs incurred during the pricing period. Following on from comments earlier in this submission, Origin has concerns regarding its ability to apply for a cost pass through if IPART assumes a carbon price in LRMC calculations that impacts upon LRET and GGAS costs, and then the carbon price is deferred.

Thank you for the opportunity to provide input into this process. If you have any questions, please contact me on (07) 3867 0620.

Yours sincerely

P.L.Wht.Wil

Patrick Whish-Wilson
Regulatory Pricing Manager