

Some Perspectives on QLD post FRC

By Stephen Weston & Liz Aitken

The implementation of FRC from July 2007 will change the face of the QLD electricity market. In this article we investigate aspects of this new and “energized” market. In particular we discuss the potential participants in the market, customer profitability and projected customer churn.

The Current State

The Sun Retail business (formerly Energex) is in the process of being sold in two tranches by trade sale. The first tranche consisted of 833,000 Sun Retail customers, and the second tranche consists of (up to) 400,000 of Sun Retail customers along with existing contestable customers of Ergon including the customers (and operations) of the Powerdirect business. This trade sale for the second tranche (known as Powerdirect Australia) is currently underway, and it is believed that five parties have been shortlisted for this acquisition. Final bids are due in February 2007.

Origin Energy was the successful purchaser of Sun Retail with a trumping \$1.202 billion bid. Valuation metrics provided by Origin¹ are:

	Value	Key Valuation Metric
Mass Market Retail (833,000 customers)	\$916 million	\$1,100 per customer
Wholesale (16 TWh)	\$220 million	\$0.61/MWh
LPG (31,000 tonnes)	\$66 million	\$2,130/tonne

If these same valuation metrics are applied to the Powerdirect Australia asset, the expected mass market portion of the purchase price would be between \$430 and \$440 million.

Does this price constitute a reasonable value?

Relevant to the assessment of whether \$1,100 constitutes a reasonable value per customer is consideration of the estimated average margin provided by the standard Queensland residential retail tariff.

¹ Source: ASX Media Release 27 November 2006 “Origin Energy acquires Sun Retail”.

Publisher

Intelligent Energy Systems ABN 51 002 572 090

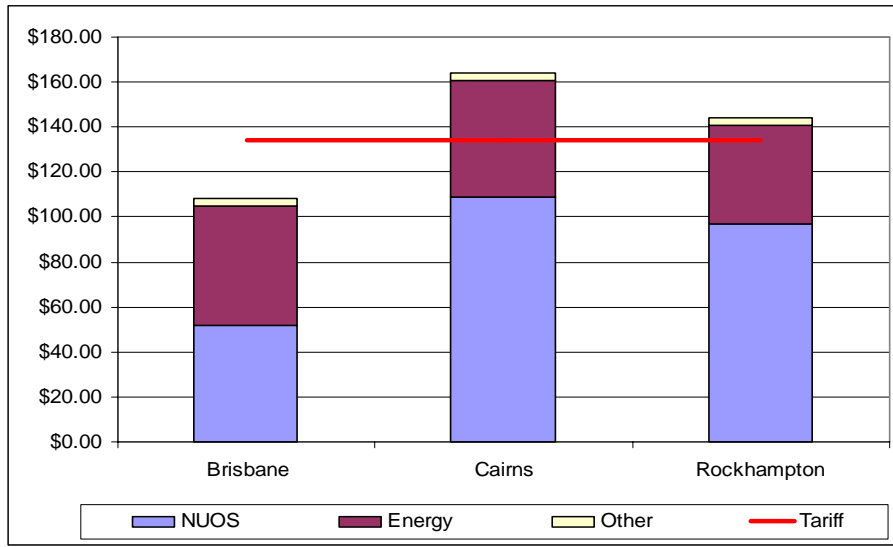


Head Office – Sydney Level 2 10-12 Clarke Street Crows Nest NSW 2065 Australia PO Box 931 Crows Nest NSW 1585
Telephone 61 2 9436 2555 **Facsimile** 61 2 9436 1218 **Email** ies@iesys.com.au **Web** www.iesys.com.au
Melbourne Level 8 45 William Street Melbourne VIC 3000 Australia PO Box 405 Collins St West Melbourne Vic 3000
Telephone 61 3 9614 6200 **Facsimile** 61 3 9614 6255 **Email** ies@iesys.com.au **Web** www.iesys.com.au



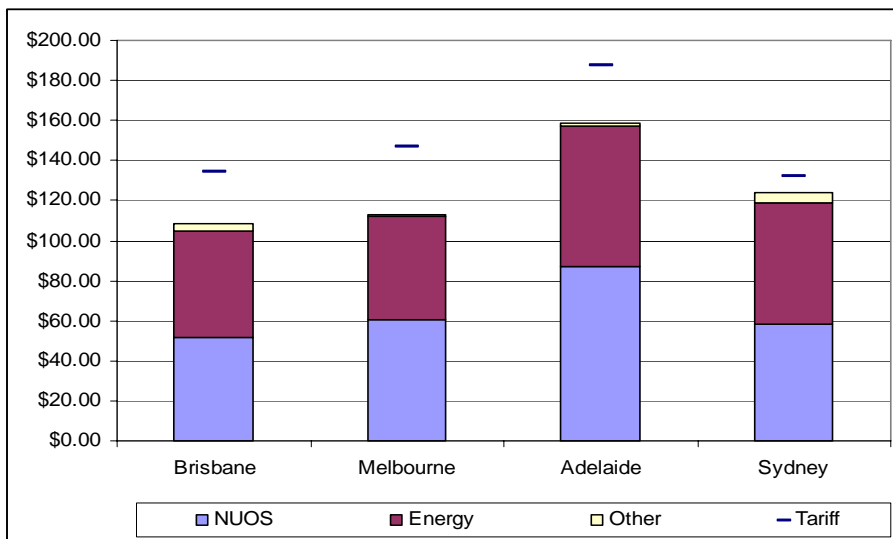
We define this retail margin as the revenue from the retail tariff less wholesale energy purchases less NUOS charges less other charges consisting of NEMMCO participant fees, ancillary services costs, and compliance with the relevant renewable energy, greenhouse gas abatement, and gas incentive schemes based on a customer having a representative annual consumption.

Estimated margins based on Queensland's Tariff 11 - domestic (lighting, power and continuous hot water heating), are shown for three locations in Queensland, Brisbane, Cairns and Rockhampton.



Brisbane shows a positive margin of 19%. Tariff margins are negative in Cairns (-22%) and Rockhampton (-7%) principally owing to high NUOS charges.

For comparison we have also estimated margins for residential tariffs in other NEM regions using our estimates of the wholesale energy costs of supplying the relevant net system load profiles of AGL (Victoria), ETSA Utilities (South Australia), and EnergyAustralia (New South Wales).



We note that with respect to margin, Brisbane compares favourably to other contestable regions of the NEM. Our estimated margins are Brisbane 19%, Melbourne 23%, Adelaide 15%, and Sydney 6%.

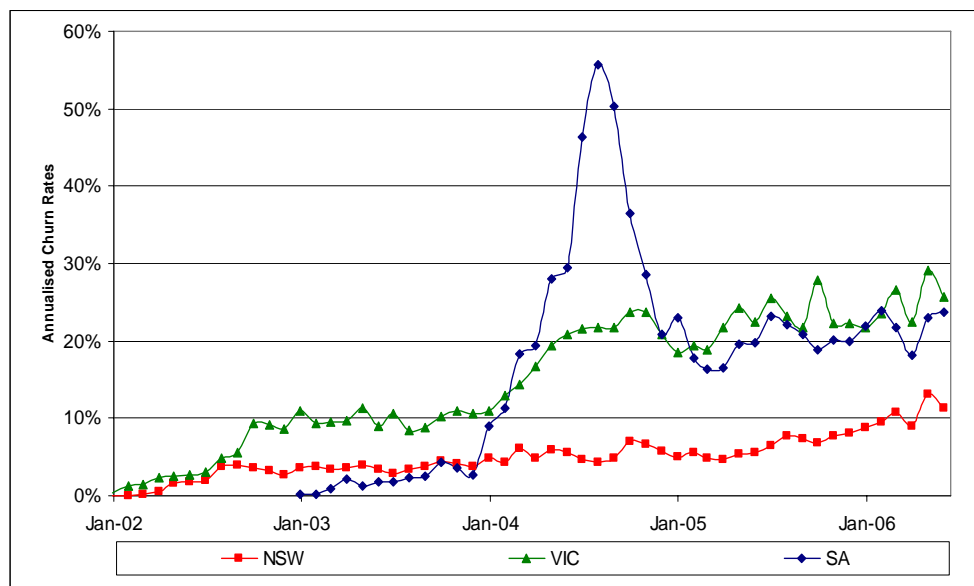
If the average annual margin per customer for the Sun retail mass market portfolio is in the order of \$190, then the average payback period for Origin Energy is 5.5 years per customer. This is of course assuming that the QLD government does not reduce tariffs during this period, and thereby reduce margins. But can Origin hold onto these customers in the face of competition from new entrants into the market?

Customer Churn

To help answer this question we refer to historical churn rates in other regions of the NEM.

Experience in other NEM regions

Full retail competition in electricity commenced in New South Wales and Victoria on 13 January 2002 and in South Australia on 1 January 2003. The annualised churn rates of these markets are shown below.



Churn has generally started slowly before increasing in all regions. In the Victorian region annualised churn reached 10% after the first 12 months and increased to 20% after the second 12 months. Churn is currently averaging around 25%. In the South Australian region churn averaged around 2.5% for the first 12 months before increasingly rapidly, peaking at 55% in August 2004 (some 18 months after commencement)². Churn is currently averaging around 20%.

Churn in New South Wales averaged less than 2% for the first 12 months and increased to an average of only 3.7% for the second 12 months. It has been steadily increasing and is now averaging around 10%.

² According to ESCOSA, these high rates of churn were influenced by an Electricity Transfer Rebate (ETR) of \$50 provided as a one-off rebate by the State Government to customers moving onto market contracts until 13 August 2004.

There are three principal reasons that help explain the comparatively low churn rates for the initial six to twelve months of full retail competition. These are :

- the requirement to bed in new systems and processes before launching large scale marketing and sales campaigns,
- initial low margins in existing tariffs, and
- initial low customer responsiveness as a result of insufficient awareness.

All of these appear to have contributed to the low churn rates in New South Wales, Victoria and South Australia during the initial period of FRC.

Projections of Churn in QLD

Given the experience of retailers with FRC in other regions, is Origin's payback time reasonable?

If QLD experiences outturns similar to that of NSW, then a 5.5 year payback period would be reasonable. In this case there would be between 2% and 4% churn. The potential net loss implied by this churn rate would not add a great deal of time to the overall payback period.

We believe however, that the churn rates in QLD will be greater than the levels achieved historically in NSW. This is based on our view that initial margins will be attractive and that retailers will be better prepared than they were at the start of FRC in the other NEM regions. This will result in customer discounts for contracts (generally 3 years in other regions) and we would expect a significant churn rate to be achieved relatively quickly. Based on the experience of AGL in South Australia, it is expected that Origin, as the largest retailer in QLD, will be the hardest hit by churn. This will serve to extend the payback period beyond 5.5 years.

Likely Outcomes

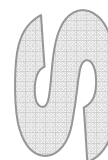
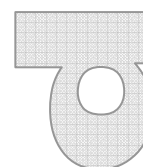
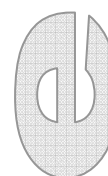
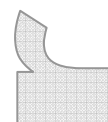
What do we see as being the state of the market in Queensland beyond FRC?

Competition

Given the price paid per customer for Sun retail, what strategies are Origin Energy and the as yet unknown new owner of Powerdirect likely to employ to protect their customer bases? At the least any strategy employed is likely to include that of pre-emptively moving the highest margin customers onto market contracts. However as this strategy entails the sacrifice of existing margin, it is possible that they will monitor early trends and respond defensively.

We expect the Queensland mass market to be keenly contested. The focus will be overwhelmingly on the high growth South-East region where the most profitable customers are located. Initially highly targeted customers are expected to include those with relatively higher annual consumption. Active competitors to Origin are likely to include AGL, TRUenergy, EnergyAustralia, Integral Energy and Country Energy. Other retailers likely to be attracted to Queensland would be Jackgreen, Victoria Electricity, and Momentum Energy.

It is expected that retailers will offer discounts to the existing tariff in the range of 5%-10%. A typical offer could be expected to provide an annual rebate of \$50 providing a headline saving of \$150 for a three year contract. The gas mass market in Queensland becomes fully contestable concurrently with electricity, therefore in



line with the rapid increase in the number of dual-fuel (gas and electricity) accounts in the other NEM regions, it is anticipated that AGL and Origin Energy will actively promote dual fuel offerings.

Owing to the lack of publicly available data in Queensland in respect of the number and average consumption of customers by tariff class, customer profiles (including billing data and load research), the size and profile of controlled loads and the net system load profiles³, some retailers will be at an informational disadvantage compared to others. Any competitor that has done due diligence as part of the sale process can be expected to have access to information that will enable more accurate targeting of profitable customers and more precise estimation of margins, however the remainder will be at a significant disadvantage – an issue that should be addressed by the QLD government as soon as the Powerdirect sale is completed.

Likely Competitive Dynamics

Presently energy purchase costs incurred by retailers for franchise customers in Queensland are subject to the Long Term Energy Procurement Arrangements (LEP). While not privy to the details of these arrangements, we understand that they have served to support the wholesale contract price at a level higher than that suggested by supply and demand fundamentals and antecedent spot price averages. It is further understood that these arrangements, which specify a minimum forward contracting requirement, have resulted in Energex and Ergon being highly hedged. Notwithstanding this support, wholesale contract prices in Queensland have commenced falling – both in nominal and real terms.

With the new 750MW single unit Kogan Creek generator due to enter service in September 2007, the Queensland region is projected to be oversupplied by generation until 2010 when a large peaking requirement emerges. We expect pool prices to be soft through 2007-2008, however, it is understood that the market is already relatively highly contracted over this time and large volumes may be in short supply. However from 2008-2009 contract levels are projected to be low, reflecting both oversupply conditions and low pool prices.

High levels of retail competition will require those retailers without a generation position in QLD to cut energy purchase costs as much as possible. This dynamic will act to drive the contract price downwards with retailers under pressure to extract margins from lower retail prices. In the worst (high risk) case retailers will take volume to the pool rather than enter into contracts, particularly where the pool has shown little or no volatility. This is likely to happen in the initial stages during off-peak, with retailers limiting exposure through the use of caps. The result is that QLD generators face a difficult financial period until the volume of oversupply is reduced.

Our Conclusions

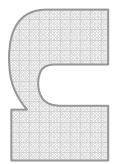
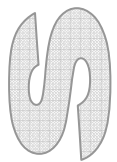
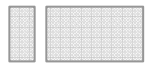
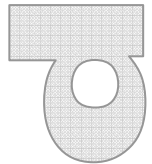
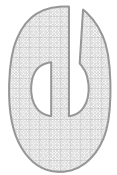
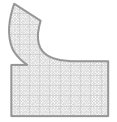
There is no doubt that Origin paid a significant price for each retail customer, particularly given regulatory uncertainties regarding tariff and NUOS resets, expected levels of competition – and associated discounts, and projected levels of

³ It is anticipated that NEMMCO will make a limited amount of net system load data available to market participants some months prior to the commencement of FRC in Queensland.

customer churn. Having paid such a high price it is to be expected that Origin will work hard to lock customers in to 3 (or more) year market contracts to protect value even before FRC starts on 1 July 2007.

In the longer term Origin has strategic advantages that assist in managing the risks. Origin has access to competitively priced gas with which to offer dual fuel deals to QLD customers, and the capacity (and announced plans) to build generation plant that will assist in increasing their per customer margin.

Only time will tell how successful Origin's strategy will be, but it has to be rated as a bold play.



Disclaimer

Please note that the articles that appear in Insider are generally written by individuals at IES and that the views expressed are the views of the individual authors and do not necessarily represent the views of IES or of other individuals at IES.