



30 January 2019

Mr M Crudden
Director Price Monitoring and Regulation
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Email: RetailEnergyReview@esc.vic.gov.au

Dear Mr Crudden

RE: VICTORIAN DEFAULT OFFER STAFF WORKING PAPER

Origin Energy (Origin) appreciates the opportunity to provide a submission in response to the Essential Service Commission's (ESC) staff working paper on the development of a method to calculate a Victorian Default Offer (VDO) for residential and small business electricity customers.

We recognise that the ESC is bound by the requirements of its terms of reference. However, we believe it is vitally important that the ESC ensure that its method and decision produce results that balance the objective for a regulated tariff to provide a safeguard for consumers who do not engage in the retail market with preserving the benefits of a competitive market.

Introducing a regulated price carries significant risks to the efficient operation of a market from regulatory error. If the VDO price is set too high, then we would expect more intense competition will compete away any excess margin over time. However, given the requirement to exclude headroom and only include modest customer acquisition and retention costs, this outcome is unlikely. On the other hand, if the VDO price is too low, then this will more likely reduce dynamic efficiency with losses to consumers. This is a greater risk.

Over the longer term, under-compensation resulting from regulatory error is likely to reduce competition, stifle innovation and result in outcomes where those most active in the market do not obtain the rewards they otherwise should. In this circumstance, competition will be slow to recover to pre-error levels. Furthermore, imposing retail price regulation will not address the material upstream drivers of electricity costs.

We believe that the most effective and sustainable response to address a number of current market problems is not through price regulation but through policies that promote understanding to enable customers to obtain better deals. As equally important, any policy response should avoid penalising those most active and engaged consumers by artificially constraining the best deal these customers could otherwise obtain.

Finally, we believe the application of a VDO should be a temporary measure. Using its monitoring and reporting functions, the ESC ought to assess the impact of the VDO against clearly defined assessment criteria. This ought to provide an objective assessment of the costs and benefits of the VDO and support a decision regarding the appropriate duration regulated prices should apply in a competitive market.

Origin's responses to specific issues raised by the ESC are provided at Attachment A. For the purposes of this response, references to the ESC means the staff working paper.

We recognise the ESC is under tight timeframes. We look forward to working closely and cooperatively to support the ESC to complete its determination of a method to calculate a VDO that will achieve an optimal balance between reforms that protect disengaged customers while preserving the ability of the competitive market to recover efficient costs.

If you have any questions regarding this submission, please contact Sean Greenup in the first instance on [REDACTED].

Yours sincerely

A handwritten signature in blue ink, appearing to read "K. Robertson". The signature is written in a cursive style with a horizontal line at the end.

Keith Robertson
General Manager, Regulatory Policy

Attachment A

Question 1: Is the definition of a notional retailer suitable for the Victorian retail energy market? What alternatives could the commission consider for the VDO?

The VDO will be based on the concept of an efficient representative retailer rather than any individual retailer's costs.

The ESC propose that a representative retailer is one that:

- has achieved economies of scale;
- is not vertically integrated;
- serves domestic and small customers and offers both standing and market contracts;
- defends its customer base; and
- does not adopt a loss leading pricing strategy.

The definition of a representative retailer is important because it will affect the specific cost items that should be included in the estimates of retailer operating costs (ROC) and customer acquisition and retention costs (CARC), and the appropriate levels for these costs. The ESC has proposed a definition of a representative retailer that reflects an established incumbent that does not loss lead. The costs of this retailer also reflect that it has achieved economies of scale.

Setting a regulated price based on this definition would therefore dissuade new entrants who would otherwise require additional margin to attract and retain new customers during a market entry phase. Over time, competition would erode any excess margin and the introduction of new entrants is intended to drive innovation.

Regulators typically balance the desirability of setting an efficient price with one that promotes or retains competition by including an appropriate allowance for CARC and a competition allowance such as the standing offer adjustment applied by the Queensland Competition Authority.¹ However, we note that the ESC has been directed to include only a modest allowance for CARC. Therefore, to ensure that competition is not impeded, we believe that the ESC ought to carefully consider the implications of its definition and how this translates into the calculation of its other cost elements.

Question 2: Please provide your views on the time period, buying curve and load profile that are most suitable to the Victorian electricity market

The ESC has indicated that its preferred method to forecast wholesale electricity prices is a market-based method that uses publicly available data and is replicable. We support this approach.

The key calculation assumptions the ESC will undertake using this method is a forecast load profile and the forward-looking cost of energy.

At its VDO workshop held on 21 January 2019, The ESC (via Frontier Economics) proposed using Victorian manually read interval meter (MRIM) data. All these sites will have an annual consumption of less than 160 MWh.

As Origin understand, the MRIM data covers historical usage for the last six years. The ESC has suggested that it could use one of these years as a representative year or it could undertake a Monte Carlo simulation and select a sample year.

¹ QCA, Regulated Retail Electricity Prices for 2018-19, Final Determination, May 2018, p. 53.

It is important that the ESC develop load simulations that adequately represent the variability in customer load (particularly peak demands) that retailers experience. The underlying demand data used to project load scenarios should be drawn from an extensive history that includes weather extremes. We would expect that the ESC request complete sets of half hourly data from AEMO and network businesses to support its analysis; a small sample is not adequate. We note that even if only six years of load data is available, greater weather variability can be simulated using the relationship between weather variables (for which there is a longer history of reliable data) and load; this is the approach the QCA applies. A tight range of demand distributions naturally leads to a more efficient 'model hedge position' in turn understating modelled energy costs.

In terms of the calculation of forward looking energy costs, in summary the ESC proposes developing a set of characteristic wholesale prices; scaling these prices to estimate the average spot price for the representative pattern of consumption; and then determining an efficient hedging strategy to manage the average spot price exposure for the given load.

The key aspects of this approach are that the ESC assumes a contract premium of 5 per cent and calculates the average prices of quarterly based swaps across a 40-day averaging period. The ESC indicate that a 40-day average price provides the best indicator of the market's view of prices for the regulatory period. The rationale for a 40-day average price is to avoid the possibility of gaming the regulatory arrangement.

In adopting a market-based approach, we believe it is vitally important that the 'model hedge book' assumed is realistic, that futures prices are averaged over an appropriate period, that load shapes exhibit realistic diversity, and that pool prices have a reasonable distribution and correlation to load. The hedge book should not be determined ex-post to optimise the load outcomes. Origin has previously observed perverse regulatory modelling outcomes where a 'long cap position' coupled with high cap payouts delivers a lower energy price allowance, i.e. insurance was modelled as a benefit rather than is usually the case a cost.

We believe determining the hedge strategy of the representative firm is to a large extent a theoretical exercise. However, the ESC can inform its analysis by observing market outcomes in the retail sector. We accept that choosing a short averaging period is available to retail businesses. However, we believe that most retail business hold a diverse portfolio of hedge contracts entered into over an extended period of time. This means that a retailer will only need to hedge a proportion of its load at any point in time. Holding a portfolio of hedge contracts allows the retailer to manage its wholesale exposure. We believe it is highly unlikely that an efficient hedging strategy would involve a retailer accessing hedge markets from time to time when conditions are considered favourable and not seeking to hedge prices at a time dictated to by each regulatory decision. We note the AER has adopted a similar approach when considering debt costs, moving from an on-the-day method to a 10-year rolling average over an extended period.

Therefore, Origin supports the use of futures prices in estimating electricity wholesale costs that are averaged over a period that reflects the time over which a retailer acquires hedges in practice (one to two years).

Question 3: How should the commission calculate transmission losses?

Origin supports the use of transmission and distribution loss factors published by AEMO in a manner that aligns with AEMO's settlement process.

Question 4: Are the tariffs set out in Tables 1 and 2 the appropriate tariffs for establishing the VDO?

The ESC has proposed using the simplest underlying network tariff for each distribution zone as the structure for the respective VDO in each network. For Citipower, Jemena and Powercor these are single rate usage tariffs. For, United Energy this is a seasonal tariff while Ausnet uses a two-block tariff structure.

However, as part of the network tariff reform process, the networks are being encouraged to adopt more complex cost reflective tariffs, including for default tariffs. We seek the ESC's views regarding whether it would in future apply more complex tariffs if these were applied by the networks. We also seek the ESC's views on how it proposes to address the risk in the event that a network assigns a customer on a VDO to a different more complex network tariff; as the financial risk of this mismatch will reside with the retailer.

We also seek confirmation from the ESC that regardless of the structure of the VDO, that retailer will be able to make market offers using a different tariff structure. This is especially relevant to the extent that networks have multiple tariff structures and retailers seek to manage the risk of presenting these different structures to their customers.

Furthermore, we also seek clarification with respect to how the VDO will interact with recommendation 4A of the Thwaites review. Notably, recommendation 4A requires retailers to commit to fix any price they are offering for a minimum of 12 months. If the VDO changes during a customer's contract period, how will retailers be expected to manage this price change.

Question 5: How should the commission treat the calendar year network revenue determinations in the context of the introduction of the VDO from 1 July 2019?

Origin considers that the timing of regulated retail prices and regulated network tariffs should be aligned. Future VDO determinations should commence on 1 January to facilitate this. While we believe it would be preferable to align the retail and network pricing windows from the outset, we recognise that the ESC's terms of reference does not permit this.

As a result, the ESC needs to ensure that changes in costs to take effect from 1 January 2020; notably network costs, are appropriately reflected in the VDO.

Question 6: Do you agree with the commission's proposed approach of using benchmarking? If not, why not, and what alternative approach should we consider?

The ESC proposes a market-based approach for forecasting environmental costs. For LRET costs the ESC propose to determine these as the loss adjusted electricity multiplied by futures market prices and by the Clean Energy Regulator's renewable power percentage with an upper bound go the penalty rate.

With respect to the SRES, the ESC proposes a loss adjusted electricity volume multiplied by the clearing house price of \$40 and the CER's small-scale technology percentage.

Origin supports the ESC's proposed use of the contract market to estimate LGC prices. However, the ESC ought to recognise that retailers acquire LGC's over a reasonable period; indeed, many retailers secure much of their LGC requirement through long term PPAs.

Specifically, the forward price curve for LGCs is in decline reflecting the anticipated delivery of enough large-scale renewable generation to meet the peak Renewable Energy Target in 2020 and no planned extension of the scheme. The ESC should carefully consider whether its approach of using the market price will adequately compensate retailers for their prudent LGC costs over the remaining years of the scheme. Retailers have progressively invested in renewables or entered into PPAs over the duration of the scheme with prices for earlier renewable projects generally made at a significantly higher price point, which may now be in excess of the current LGC/energy market price. There appears to be a risk of a perverse regulatory outcome over the remaining years of the scheme if the current LGC market price is applied without adjustment. Retailers will effectively be penalised for acting commercially and prudently by supporting sufficient renewable investment to meet scheme obligations.

However, the decline in LGC prices is a consequence of policy/regulatory mechanisms rather than market conditions. The RET will peak in 2020 with no replacement carbon scheme in place to provide

value for renewables. The marginal value of an LGC has fallen because retailers collectively supported enough renewable build to meet their legislated RET obligations. Had this not been the case then renewable supply would be reduced and the LGC market price would naturally be higher.

With respect to SRES, small scale solar installations continue to experience a rapid growth in the rate of installation. This growth has outstripped the CER's estimates of the volume of small-scale certificates (STC) created.

We note that the most recent update from the CER in December 2018, indicates a significant surplus of STCs created in calendar 2018 estimated at around 6-8 million STCs, this represents a variance of over 20 per cent above the published small-scale energy percentage (STP). As the final binding STP for 2019 will not be published until March 2019, we suggest the ESC consults with the CER to obtain an up to date estimate for inclusion in the ESC's draft determination.

Further, as the calendar 2020 STP is also relevant to this determination, we suggest that the ESC also consider the CER's current non-binding STP.

For these reasons, we consider that the ESC should apply a \$40/certificate allowance for SRCs given this is the full value available to those surrendering certificates.

We would be happy to discuss our view of the calendar 2020 STP based on our expectations of the rate of installation.

The ESC will also need to make an allowance for other wholesale costs, these include:

- prudential capital costs – the costs a retailer incurs to provide financial guarantees to AEMO and lodge margins with the ASX or other hedge providers;
- NEM management fees and ancillary services charges;
- Reliability and Emergency Reserve Trader (RERT) costs – AEMO is expected to incur RERT costs again next year. These are significant for Victoria; and
- AEMO directions costs - additional costs incurred as a result of directing generation outside the usual settlement process; an ongoing cost until Electranet commissions synchronous condensers.

Question 7: What should be included as the efficient retail operating costs and a modest customer acquisition and retention allowance?

There is an obvious tension when considering ways to reduce CARC while still retaining the desire to promote vigorous competition between retailers. Fundamentally, these costs are driven by retailers' competitive efforts to win and retain customers which ordinarily should be expected to drive efficiencies and lower costs over the long term.

The risk for the ESC is that its sets its ROC, and therefore its VDO, at level that does not allow a number of retailers to recover their full efficient costs.

To mitigate the risk of under-estimation, we believe the ESC ought to carefully consider the impact that constant changes to the regulatory regimes are having on regulatory costs; and notably in Victoria where there are distinct differences between its regulatory regime and the NECF.

We do not support 'benchmarking' other regulators' operating cost determinations as no regulator currently performs a robust operating cost assessment. Specifically:

- the QCA is the only regulator that currently estimates operating costs and its estimates are based on subtracting network and wholesale cost estimates from market offers revenue. i.e. the combined operating cost and margin is a balancing item;

- IPART no longer regulates prices and its cost estimates are too old to be accurate. The last assessment was in June 2013 based on FY13 retailer data; and
- the ICRC estimates operating cost based on IPART's benchmark (established June 2013) that has subsequently been indexed by CPI. The ICRC operating cost estimate for FY17 (\$119.31 per customer) is substantially below major retailers publicly reported operating costs (Origin reported a cost to serve and acquire of \$146 for FY17).

We believe the ESC should use publicly reported operating costs (audited annual accounts) to assess operating costs to which an adjustment should be made for foreseeable regulatory changes. The ESC should include an allowance for retail depreciation and amortisation expenses, e.g. IT expenses are often capitalised and can form a substantial cost component. Allowance should also be made for funding working capital and meeting the prudential requirements of operating in wholesale and associated financial markets.

Origin understands that the ESC has been tasked with determining a reference price that excludes an allowance for 'competition' costs. Even if competition costs are excluded this should not preclude an allowance for some marketing costs. All businesses, even monopoly services, incur marketing expenses to develop appropriate services for customers and ensure their services are understood and appropriately used.

The ESC should carefully consider likely changes to retailers' cost structures. Several recent and planned regulatory changes are likely to add to the cost of doing business. For instance, changes to customer notice requirements, presentation of tariffs, changes to hardship arrangements, and changes to the structure of mandated feed in tariffs. Implementation of the Expert Panel report recommendations will also add to retailers' costs. The ESC's VDO should accommodate the reasonable costs of foreseeable regulatory changes.

Question 8: For electricity retailers – how readily can you separate customer acquisition and retention costs from other operating costs? What issues might the commission need to consider?

Origin is able to readily provide disaggregated information between CARC and operating costs. In assessing this information, the ESC needs to be mindful that operating costs cover a broad range of activities and to the extent that the ESC propose a limited range of reporting categories this could leave a large amount considered as other costs. The ACCC did not include these "other" costs in its assessment of NEM wide retail costs.² We believe this was erroneous. For this reason, the ESC ought to consider the broad nature of retail costs and seek to understand the full suite of these costs before excluding any category in its assessment.

Question 9: Are there any other costs incurred by an electricity retailer that the commission should consider? Why?

The ESC acknowledges that there are a number of additional costs such as AEMO market fees, ancillary charges, license fees, and efficient prudential cost of participating in the wholesale and associated financial markets that need to be considered as part of its cost stack. In addition, we believe the ESC ought to also consider the impact of solar feed in tariffs. Specifically, the costs incurred by retailers to purchase electricity from customers at the mandated solar feed in tariff.

The feed-in tariff incorporates a value for avoided emissions. In Victoria, for a typical 3kW system, this represents a subsidy of over \$2,000 over fifteen years. As a result, the feed-in tariff in Victoria increased by 2.5 cents from 1 July 2017. The additional cost of the mandated solar tariff including the emissions subsidy will ultimately be recovered through energy prices to all consumers and should be recognised in the VDO.

² See ACCC, Retail Electricity Pricing Inquiry – Final Report, June 2018, p. 221, footnote, 473.

As Origin noted in its recent submission to the ESC regarding Feed-in Tariffs³, the wholesale allowances for the VSO and FiT should be calculated using the same futures price data set.

Question 10: Does this proposed structure provide a simple and practical approach to deal with the variety of standing offers?

Because the ESC will adopt different tariff structures across the different networks, it will be necessary to make a decision regarding the allocation of fixed and variable costs across multiple prices.

For this reason, the ESC needs to apply a consistent and verifiable method across each network that results in a representative of actual residential average usage. This should also be consistent with the Victorian Energy Compare usage assumptions.

Furthermore, the ESC has suggested using a consumption weighted average maximum price for all tariffs other than fixed and flexible. Origin finds the ESC explanation unclear and requests greater clarity regarding this proposed method.

³ Origin Submission to ESC re Victorian feed-in tariff rates to apply from 1 July 2018 - Draft decision
<https://www.esc.vic.gov.au/electricity-and-gaselectricity-and-gas-tariffs-and-benchmarks/minimum-feed-tariff#tabs-container2>