14 November 2024

Natalie Elkins
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Australian Energy Regulator
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Canberra ACT 2601

Submitted by email: DMO@aer.gov.au

Dear Ms Elkins,

Default market offer prices 2025-26 – Issues Paper

Origin Energy Limited (Origin) welcomes the opportunity to provide comments on the Australian Energy Regulator's (AER) Default market offer (DMO) prices 2025-26 Issues Paper.

The DMO objective requires prices to be set at a level that allows retailers to recover efficient costs, while also facilitating competition, and ensuring that customers are protected from unreasonably high prices. We recognise the significant challenges faced by the AER in balancing the inherent tensions between these objectives. We share a common objective of wanting to improve customer outcomes and to further develop an industry capable of navigating the energy transition.

It is within this context we have framed our discussion of the various matters raised in the Issues Paper.

Wholesale Energy Cost (WEC)

We appreciate the AER's engagement on the technical aspects of the WEC modelling and support the proposal to incorporate additional variability in key inputs to improve its accuracy. Wholesale spot price modelling should ultimately reflect the range of potential scenarios a retailer could be exposed to. As previously noted, Origin is concerned this objective is not being adequately satisfied under the current approach, given the relatively low spread of sub $300/MWh (energy) prices modelled. Incorporating variability in fuel prices and plant outage levels should assist with addressing this, as these factors can have a material impact on energy prices.

An assessment of the performance of the model over time using actual spot price / demand data should be undertaken. This should include assessing whether actual spot price outcomes fall within the range of modelled prices, and deriving an updated WEC using actual spot price / demand data for comparison with the modelled WEC applied for each DMO period.

While we recognise the challenges the AER has faced deriving load profiles because of data adjustments outside its control, it is vital that the AER avoid making subjective decisions. We support the AER's modellers (ACIL Allen) recommendation that an adjusted net system load profile blended with interval meter data should be used to determine load profiles to calculate the WEC.

We contend that adopting the 95th percentile would be more appropriate given the range of modelling uncertainties and risk that modelled WEC estimates may not reflect the actual costs incurred by a prudent retailer during a DMO period.

Retail Allowance

The change in the calculation of the competition allowance from an aggregate margin on the cost stack to a fixed value represented a significant departure from the approach adopted in previous decisions.

Despite this significant change, the detail to enable stakeholders to fully assess or comment on the AER's approach has not been provided.

We consider it crucial that the specifics on the method used to determine the competition allowance be provided and that a clear and objective process for reintroducing the allowance is set out.

Against the trend of growing risks for retailers, our view is that current margins should at a minimum be retained, with the AER being mindful for the need of any increase, particularly while the competition allowance remains suspended.

Network Prices

It is appropriate for the AER to consider how best to reflect changing network tariff structures in the DMO. However, it does not yet appear that the AER has access to reliable and consistent usage data to allow for the blending of flat and TOU network costs. Given this, it is appropriate that the AER retain its current approach of using flat tariffs.

In terms of the actual costs, in the absence of approved network prices, the AER should use prices submitted by the networks in their annual pricing proposals for 2025-26. These prices represent the best information available in that they should reflect the recently approved revenues and demand forecasts from the AER's revenue determination.

If you wish to discuss any aspect of this submission further, please contact Sean Greenup (sean.greenup@originenergy.com.au) or Shaun Cole (shaun.cole@originenergy.com.au).

Yours Sincerely,

Steve Reid
General Manager, Regulatory Policy

1. Wholesale energy cost

[1]   The Issues Paper identified several matters for consideration with a view to addressing identified issues and ensuring the WEC methodology remains fit for purpose. These include how to best estimate the load profiles and controlled load profiles, the approach to determining hedging costs in South Australia (SA), and whether and how to introduce greater variability to the inputs and assumptions used in the wholesale forecasting methodology. We have addressed these matters in further detail below.

1.1 Load profile assumptions

[2]   The AER's preferred approach to date has been to use a blended profile of AEMO's NSLP and interval meter data. A key reason has been to manage the risk of a step change in the WEC from moving fully to the use of interval meter data.

[3]   However, the AER departed from this approach for DMO 6 because of an issue relating to negative demand values coinciding with the commencement of 5MS. This adjustment resulted in an "artificial uplift" to the Energex and SAPN NSLP traces. In response, ACIL Allen recommended that the AER take its usual approach and use actual NSLP data from 1 July 2021 to 30 June 2023 but remove the artificial uplift given it will not be present in 2024-25. Origin supported this approach.

[4]   Instead, the AER adopted the midpoint between AEMO's non-adjusted NSLP and ACIL Allen's adjusted NSLP.

[5]   The artificial uplift was temporary and ceased from 1 October 2023. This means the artificial uplift will not impact retailers in 2024-25 and therefore its use for the 2025-26 DMO.

[6]   It is important that the AER adopt a method that is consistent and repeatable. We support the AER retaining its approach of using the NSLP and blending this with interval meter data. Currently there are marginally more accumulation meters than interval meters so retaining a blended approach offers the best representation of this split. This approach also has the advantage of using the latest available NSLP and interval meter data which means the spot price modelling is based on the latest system demand traces.

[7]   For this reason, we support the use of only one year of NSLP data to simulate the load profile, from October 2023 to October 2024, blended with interval meter data.

[8]   We also believe this will support a more gradual and lower risk transition to full interval meter data by DMO 8, by which time the penetration of interval meters will significantly exceed accumulation meters.

[9]   In terms of the controlled load profile for NSW, we support the use of historic CLP to forecast the load shape for DMO 7. Despite the increased penetration of interval metes we do not believe there has been a significant shift in the load shape in NSW. We believe this will allow for the CLP to transition to interval meter data in DMO 8 consistent with our proposed timing for the mass market load profile.

> **Recommendation**
> - We support the AER using a blended profile to develop the load profile and controlled load profile for all networks.

1.2 Wholesale spot price modelling

Varying key wholesale modelling inputs could improve the accuracy of the WEC

[10] Wholesale spot price modelling should ultimately reflect the range of potential scenarios a retailer could be exposed to. This should in turn inform the hedging strategy adopted in the modelling, which acts to limit the retailer's financial risk in those scenarios. Given retailers often conceptualise their exposure to the spot market in terms of sub $300/MWh (energy) and above $300/MWh (capacity) prices and hedge those risks in different ways, capturing potential variability in both energy and capacity prices is important.

[11] As previously noted, Origin is concerned this objective is not being adequately satisfied under the current approach. The spot price modelling notionally indicates a wide range of potential market outcomes when considering the annual time-weighted spot prices (which account for prices above and below $300/MWh). However, Origin's estimation of average annual energy prices for DMO 5 and 6 demonstrates there was only a $7/MWh and $9/MWh differential between the minimum and maximum energy prices modelled in New South Wales across those respective periods. Where the model does not adequately reflect potential volatility in both energy and capacity prices, this could contribute to the adoption of a hedging strategy and / or lower hedging costs than what a prudent retailer may incur in practice.

Table 1: Estimated range of energy (sub $300/MWh) and capacity (above $300/MWh) prices modelled for DMO 5 and 6 (NSW, $/MWh) [1]

	FY2023 (DMO 5)			FY2024 (DMO 6))		
	Min	**Max**	**Range**	**Min**	**Max**	**Range**
Contribution of prices over $300 to annual average spot price	11	69	58	3	70	68
Contribution of prices under $300 to annual average spot price	74	81	7	73	82	9

[12] Origin agrees with the AER's contention that incorporating additional variability in modelling inputs should translate to simulated energy prices that more closely align with the volatility observed in the National Electricity Market (NEM).[2] In this context, we are supportive of the modelling being updated to incorporate the impact of potential fuel price variability, as fuel prices are a key driver of energy prices. This is consistent with the AER's decision to apply a winter and non-winter gas price in DMO 6, with the AER noting there was clear evidence that market conditions were more varied than what a single annual input could reflect.

[13] We also recommend testing greater variability in thermal plant outages. Currently, the modelling appears to only test variability in the timing, rather than the overall level of outages, which can have a material impact on spot market outcomes, particularly when coincident with low variable renewable energy (VRE) output.

[14] It would be appropriate to consider high / low fuel price and outage scenarios, informed by historical variability in those parameters. Any assumptions underpinning these scenarios should

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[1] The contribution of prices under $300/MWh has been derived by subtracting the 'Contribution of spot prices above $300 to annual average spot price ($/MWh)' from the 'Annual regional time weighted spot price ($/MWh)' from the following resources: ACIL Allen, 'Default market offer prices 2023-24 (Final Determination) – Summary results of market simulation', 25 May 2023; ACIL Allen, 'Default market offer prices 2024-25 (Final Determination) – Summary results of market simulation', 23 May 2024
[2] AER, 'Default market offer prices 2025-26 – Issues Paper', 11 October 2024, p. 23.

also be transparently outlined to ensure stakeholder have an opportunity to meaningfully comment on their application.

> **Recommendation(s)**
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> ▪ For FY2026, scenarios should be developed that allow the potential impact of the below factors on wholesale spot prices to be tested and better ensure modelled price variability is within the range of prices that could reasonably occur over time:
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> - variable coal and gas prices; and
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> - high thermal generation outages.

Model performance should be transparently tested using historical market outcomes

[15]   We recognise the estimated WEC for any determination will invariably be different to the actual WEC incurred. As noted by ACIL, the WEC is ultimately a function of several factors, including the actual hedging strategy adopted by a retailer (noting different retailers may have different strategies) compared with the simplified hedging strategy adopted in the methodology, the actual load profiles, spot price and contract price outcomes.[3]

[16]   Notwithstanding this, it would be beneficial to transparently assess the performance of the model over time using actual spot price / demand data. This includes assessing whether actual spot price outcomes fall within the range of modelled prices, and any change in the WEC when historical data is applied for a given DMO period.

[17]   Origin has previously raised a concern that the hedging strategy adopted did not sufficiently reflect that of a prudent retailer. In particular, we considered the high proportion of cap contracts and low volume of baseload swaps resulted in greater pool price exposure for the retailer and consequently a riskier portfolio when compared to the strategy used for DMO 4. We have also observed that this shift has potentially been driven by the high level of modelled positive cap contract payouts, which put downward pressure on the WEC. We maintain the hedging strategy should be resilient to different market outcomes. Assessing the model's performance against actual spot / market outcomes could provide useful insights into this issue, and the extent to which the modelled WEC is likely to adequately reflect the costs of an efficient retailer.

> **Recommendation(s)**
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> ▪ The performance of the WEC modelling should be transparently assessed using historical data. This should include:
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> - comparing the range of modelled spot prices to actual spot outcomes; and
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> - using actual spot and demand data to determine WECs for historical years.

Length of the book build

[18]   We support the existing book build process which occurs over a two-to-three-year period and agree pricing stability is important for customers.

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[3] ACIL Allen, 'Default Market Offer 2024-25 – Wholesale energy and environment cost estimates for DMO 6 Final Determination', 22 May 2024, p. 28.

1.3 South Australian hedging methodology

[19]   Origin supports the AER's proposal to retain the current use of ASX Energy trade data and benchmark trade prices with broker data for swaps / caps and other OTC contract data collected. If a material misalignment in trade prices is observed, this could indicate a need to consider alternate data sources to benchmark retailer hedging costs in SA. However, it would still be important to maintain an approach that uses publicly available data that retailers would typically rely on to inform their pricing of hedging products.

[20]   We note the AER is also considering repeating analysis of the long-run marginal cost (LRMC) of generation in SA for use as a comparative data point (i.e. to compare with the WEC derived for SA using ASX Energy trade data). We maintain there is a risk an LRMC-based approach could result in a WEC that is not representative of actual retailer costs, as evidenced by the AER's finding (under DMO 6) that the LRMC-based WEC's were lower than those resulting from the current methodology. Any reliance on this approach should therefore be for comparative purposes only.

> **Recommendation**
> - Hedging costs in SA should continue to be determined using ASX Energy trade data and benchmarked with broker data for swaps and caps, and other OTC contract data collected by the AER.

1.4 Compensation costs

[21]   We agree known AEMO and AEMC compensation costs should be passed through the DMO wholesale component.

1.5 Use of the 75th percentile

[22]   Origin recognises the AER is proposing to retain the use of the 75th percentile WEC and agrees it is important to balance the allocation of risk between retailers and consumers. However, we contend that adopting the 95th percentile would be more appropriate given the range of modelling uncertainties discussed above and risk that modelled WEC estimates may not reflect the actual costs incurred by a prudent retailer during a DMO period. This is a key reason ACIL Allen has historically adopted the 95th percentile of the distribution of WECs as part of its modelling approach, which is also utilised by the QCA in setting regulated electricity prices in regional Queensland.[4] Where the 75th percentile approach is to be retained, it will be important to ensure the WEC modelling issues identified are adequately addressed.

2. Retail Costs

2.1 Retail costs

[23]   We support the AER collecting retailer cost information that replicates the cost categories requested by the ACCC and used by the AER in previous DMO decisions.

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[4] ACIL Allen, 'Default Market Offer 2024-25 – Wholesale energy and environment cost estimates for DMO 6 Final Determination', 22 May 2024, p. 15; ACIL Allen, 'Estimated Energy Costs - For use by the Queensland Competition Authority in its Final Determination of 2024-25 retail electricity tariffs', 23 May 2024, p. 14.

[24]   By using a consistent data time series this will reduce the risk of regulatory error. Reporting against a consistent set of data will also improve efficiency as businesses can rely on established data collection systems and processes to extract and report this information.

[25]   We also support the AER's proposal to collect data from an expanded set of retailers. The extended database will provide a better representation of costs faced by the wider retail sector.

2.1 Bad and Doubtful Debts

[26]   We support the calculation of bad and doubtful debts for residential and small business to continue to be based on the state-based weighted average as reported by the ACCC.

2.2 Smart meter costs

[27]   We support the AER's decision to continue the current approach of using historic installation data until the legacy meter retirement plans are in place. We also support the decision to allow a working capital allowance to cover the shortfall between actual installation numbers and projected installations.

> **Recommendation**
> ▪ We support the AER continuing to apply the retail costs categories used in previous DMO decision.

3. Retail margin and competition allowance

3.1 Retail margin

[28]   The retail margin should reflect the level of risk that a retailer faces; the greater the risk the greater the retail margin that is required in order that capital invested in the business earns an appropriate return.

[29]   More broadly, the retail allowance should provide a margin for retailers that can be used to absorb some additional costs as they arise due to inconsistencies between the DMO, and actual costs faced by retailers through the year. The level of the retail margin is particularly important given the suspension of the competition allowance which magnifies the risk of cost under-estimation.

[30]   Overall, the risks and costs of being a retailer in the NEM have not diminished since the last DMO decision.

[31]   For example, the AEMC has recently extended the release of its 'Accelerating smart meter deployment Rule change' to consider **additional consumer protections when** a customer is assigned a cost reflective network tariff following a smart meter installation.[5] This includes the ability for customers to effectively remain on flat retail tariff structures as cost reflective network tariffs are applied. If this is confirmed in the AEMC's Final Determination, the likely effect is that in most cases a retailer's actual network costs will be different to the network costs recovered

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[5] AEMC, 'Accelerating smart meter deployment, Directions Paper, 15 August 2024.

from their customers. It is not clear there is any specific mechanism that could reasonably factor this cost into the DMO other than to reflect the increased risk in the margin.

[32] Against this background and the trend of growing risks for retailers, the AER's consultant (ACIL Allen) suggested that in the interest of promoting regulatory certainty and encouraging investment, it is important that existing margins are maintained.

[33] We support the position that current margins should at a minimum be retained, particularly while the competition allowance remains suspended.

3.2 Competition allowance

[34] In DMO 6, the AER changed the calculation of the competition allowance from an aggregate margin on the cost stack to a fixed value for the competition allowance. We retain our support for a margin-based competition allowance that takes account of changes in underlying costs and therefore better incorporates movements in the commercial risks facing retailers.

[35] The change in approach represented a significant departure from previous decisions, but limited detail has been provided to stakeholders. Good regulatory practice dictates that decision making should be open and transparent. Providing specifics on the method used to determine the competition allowance will allow stakeholders to comment on the methodology and help retailers manage their financial risks including an understanding of the likelihood of future adjustments.

[36] We note previous reservations around disclosing details of the methodology due to confidentiality concerns. However, we do not consider that the identification of costs attributable to specific retailers other than what is already available in the ACCC cost data is required. Instead, it should be possible to provide details of the underlying assumptions including what cost categories have been included.

3.3 Preconditions for applying the competition allowance

[37] It is important that there is a clear and objective process for reintroducing the competition allowance. The AER indicates that the primary factor it will use to decide whether to reinstate the competition allowance is cost of living pressures as measured by 12-month movements in the CPI. Specifically, where CPI is "materially" above the Reserve Bank of Australia's (RBA) target band (of 2 to 3%) for a "sustained" period, the AER will not apply the competition allowance to prioritise consumer protection.

[38] We acknowledge that the relationship between the CPI and the RBA target band is likely to provide a reasonable proxy for cost of living pressures. The CPI captures price changes for the goods and services that households buy, and the RBA target band provides a measure of price stability in the economy. In addition, both the CPI data and RBA band are readily observable measures.

[39] However, the criteria of "material" and "sustained" are subjective. For example, how do you objectively determine if material is say 0.25% or 0.5% or whether sustained is 3 months or 9 months.

[40] The AER should make clear what the measures mean in practise. This could include providing examples or scenarios under which they are likely to reintroduce the competition allowance.

> **Recommendation**
> - We support the position that current margins should at a minimum be retained.
> - That the AER provide an explanation of its assumptions underpinning its competition allowance method including what cost categories have been included and how risk has been assessed.
> - The AER provide a clear and concise criteria for the reintroduction of the competition allowance.

4. Network costs

4.1 Flat rate and time of use network tariffs

[41] Because retailers have limited ability to manage network cost risk, it is important that the AER's method allows retailers with a reasonable opportunity to recover their actual costs.

[42] Moving to a blended approach would require the AER to estimate annual network costs under both the network's flat rate network tariff and the time of use network tariff.

[43] However, deriving an average annual time of use network cost is complex to calculate as it requires information on the amount of energy consumed in each of the networks' charging windows for an average customer.

[44] In addition, it is not clear whether the new retail performance reporting guidelines will provide the necessary usage profiles. The reporting guidelines require retailers to provide the number of customers with smart meters, their retail tariff structure, and their underlying network tariff structure. However, it is not clear how this information would provide the detail necessary to determine customers' usage across TOU charging intervals or whether the AER would need to request additional information.

[45] The risk of an inaccurate allocation of costs between flat and time of use network tariffs is that the assumed usage profiles and therefore costs included in the DMO may not reflect the actual usage profiles of a retailer's customers. Therefore, the DMO allowance will be different to the actual costs incurred.

[46] For these reasons, the AER should delay the blending of flat and TOU network costs until such time as it has more reliable and transparent usage data. This will provide regulatory consistency and maintained transparency.

4.2 Queensland and South Australian networks revenue determinations

[47] Under the DMO Code, the AER is required to publish its annual DMO prices by 26 May each year. However, in a network revenue determination year, the AER will not receive proposed network prices until 21 May. Under these timelines, there is a risk that the AER will not have sufficient time to assess and approve network prices for inclusion in the calculation of the DMO.

[48] This DMO coincides with network revenue determinations for Queensland and South Australian distribution networks.

[49] A similar situation arose in DMO 6 with the NSW network revenue determinations. To alleviate the risk of approved network prices being unavailable for inclusion in the final DMO, the AER

proactively engaged with the NSW DNSPs during the development of their pricing proposals. This allowed the AER to obtain the most recent pricing estimates and identify potential issues that could be addressed to minimise the variation between network prices used in the draft and final DMO determinations and facilitate the timely approval of network prices.

[50]   We support the AER applying a consistent engagement process with the Queensland and South Australian networks for this DMO process.

[51]   In the event the AER is still not able to approve network prices in time for inclusion in the DMO final determination, it is vital the AER use the best information available. We propose that the AER use the network tariffs contained in the network pricing proposals submitted for approval.

Recommendations

- Given potential data limitations, that network costs continue to be based on flat rate network tariffs.

- Support the use of final approved network prices. Where this is not possible, the AER should use the network tariffs contained in the network pricing proposals submitted for approval by 21 May 2025.

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5. Environmental costs

[52]   Origin supports the current market-based approach to determining environmental costs.