origin

20 March 2019

Mr Mark Feather
General Manager, Policy and Performance
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Email: DMO@aer.gov.au

Dear Mr Feather,

RE: DEFAULT MARKET OFFER DRAFT DETERMINATION

Origin Energy appreciates the opportunity to provide a submission in response to the Australian Energy Regulator's (AER) Draft Determination Default Market Offer (DMO) Price.

Within the constraints of the terms of reference, methodology and time allowed the AER's draft decision on the DMO has sought to strike a reasonable balance between lowering energy prices for 'standing offer customers' and providing retailers with a level of cost recovery that supports retail competition. Origin remains concerned about the impact of regulated pricing on competition; the AER should not adjust the draft DMO further without a comprehensive review of costs and returns. The AER should carefully consider a number of implementation issues explained below.

Origin recognises the challenges faced by the AER in making its decision on the DMO for 2019-20. These include balancing the competing objectives of setting prices at a level to address the Government's concerns around high prices for standing offer customers while at the same time not setting them so low as to create harm to the long-term competitiveness of the market.

The AER has a difficult task that has not been helped by the tight time frame it has been given nor the lack of consensus from policy makers regarding the development of a robust and well considered regulatory framework.

Certainty is a basic prerequisite of good regulation and provides a stable investment environment. When there is an inconsistency between the regulatory rules and economic principles this can undermine confidence and the legitimacy of the regulatory decision. We recognise that these are outside of the AER's control.

However, we believe the AER can reduce this regulatory risk by retaining its draft decision for its final. Delivering this consistency would send a strong and clear interpretation of the regulatory framework. In doing so, this should not be seen as establishing a precedent, rather it is a recognition of the limitations placed on the AER in performing more detailed analysis between the draft and final decisions.

This would go some way to mitigating regulatory risk and lowering costs of regulation which is ultimately carried by the community.

Origin's responses to specific issues raised by the AER are set out below.

Pricing Methodology

The Industry Code Electricity Retail (the Code) requires the AER to determine a reasonable per-customer annual price for supplying electricity having regard to allowing retailers to: 1) make a reasonable profit; 2) recover input costs; and 3) recover the costs of acquiring, retaining and servicing their customers.

The AER has undertaken a top down method to have regard to these matters. We have argued previously that any approach ought to adopt methods of calculation that are robust and appropriately capture efficient and forward-looking input costs and deliver reasonable returns on capital.

We recognise that the AER has been restricted in the time and data available to it. However, we also believe that care needs to be applied when utilising alternative sources of data to determine whether changes need to be made to forecast input costs. These are discussed further below.

Price range and Price Points

In our previous submission, we raised concerns that the AER's selected range was not representative of offers that were available over an entire year. We retain this view. While we accept the price ranges and price points are reasonable in this particular regulatory context, the AER needs to be cognisant of making further cost adjustments when additional efficiencies may be better achieved through competition.

Forecast Changes in Input Costs

The AER considered that while the forecast changes in the key input cost components between 2018-19 and 2019-20 would lead to a moderate decline in retail prices, it did not propose to adjust the proposed DMO price point given that these forecast changes were relatively modest. Origin supports this decision and considers that a more robust assessment would be required for the AER to act upon any expected change in input costs.

The AER noted that it would take into account the outcomes of the AEMC Price Trends report as well as the QCA's recent draft decision of notified prices for regional Queensland.

We consider that the AER ought to exercise caution on how it uses these sources of information taking into account the differing objectives of each report author.

The purpose of the Price Trends report is to provide an understanding of the cost components of the electricity supply chain that contribute to the overall prices paid by residential customers, the expected trends in each of the cost components, and overall prices over the relevant period. As the AEMC notes, its report does not provide, and should not be regarded as providing, forecasts of future prices including those which are set by jurisdictional regulators or governments.

One of the major considerations that the AEMC considers when forecasting wholesale prices is the ASX Energy prices. The AEMC use a portfolio of quarterly base, peak and cap hedges to cover the net system load profile (NSLP) using a 12-month and a 2-year build up of hedges. They do not use the observable trade volumes as the weights to calculate the weighted average cost of each product, but instead use an exponential build-up of the portfolio of hedges. Because of this approach, and the fact that the analysis was completed in October 2018, this means that 6 months of actual ASX Energy prices are not included in the analysis for 2019-20 (with the six-month period being October 2018 to April 2019).

To identify the impact of the absence of this data, we have observed the price data for NSW base loads for this six-month period to provide a more accurate picture of energy prices. As shown in diagram 1, this demonstrates that prices have increased notably since October 2018.

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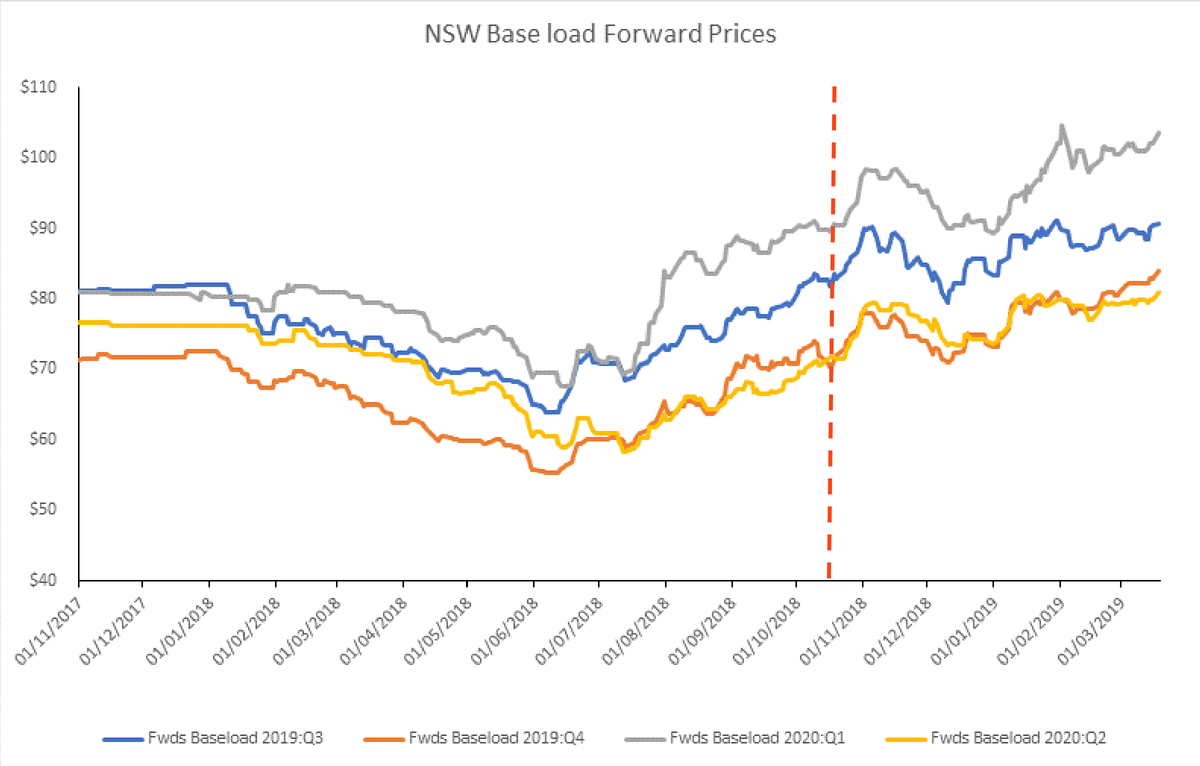
Diagram 1: Forecast ASX Energy Prices for NSW Base Loads



Source: ASX Energy Prices

For these reasons, we consider that the AER ought to retain the values of the DMO provided in its draft determination.

Other Matters

The draft Code does not require the AER to develop DMO prices for Time of Use offers. Retailers will nevertheless need to be able to calculate annual bills for TOU offers for comparison to the reference bill. We support the AER's decision to calculate annual prices using the Energy Made Easy (EME) algorithm, which incorporates TOU profiles. However, we believe more guidance is required regarding how the data provided at the AER's Appendix 6 should be applied in practice. For example, whether averages over the seasonal periods or pricing periods is permitted or required.

We also support the AER's decision to apply the most relevant climate zone as the profile for each distribution zone.

The Code allows the AER to publish a decision not earlier than 42 days after the day it publishes a draft determination. On that the basis, the earliest that the AER could publish a final determination would be 7 April 2019.

We strongly urge the AER to publish its final determination as soon as possible to enable retailers to undertake the necessary systems and billing process upgrades to be able to meet their objectives from 1 July 2019. The later this decision is made, the more onerous and costlier it will be for retailers to comply and will increase the risk of non-compliance.

Closing

Any regulatory price determination requires a regulator to develop a decision without full information. Therefore, it must estimate the relevant parameters, which will include estimation errors which creates regulatory risk.

An efficient and consistent regulatory process sends strong and credible signals of good intentions. Providing predictability around the rule making process is an essential requirement for businesses to be able to confidently plan for the future and be assured that their investments will not be threatened by unexpected changes in the regulatory environment. Unpredictability will stifle investment and innovation and adversely affect the cost structure of market participants. This is not in the long-term interests of customers.

To provide this certainty, the AER should not adjust the draft DMO further without a comprehensive review of costs and returns.

We look forward to working closely and cooperatively to support the AER to complete its review and deliver findings that will achieve an optimal balance between reforms that protect customers while preserving the integrity of the competitive market.

If you have any questions regarding this submission, please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy