



18 October 2019

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

Email: DMO@aer.gov.au

Dear Mr Feather,

RE: DEFAULT MARKET OFFER PRICE 2020-21 – POSITION PAPER

Origin Energy appreciates the opportunity to provide a submission to the Australian Energy Regulator's (AER) position paper for developing a default market offer (DMO) for electricity retail services for 2020-21.

Origin supports the introduction of the DMO as a safety net for customers that cannot meaningfully engage in the market, and in better enabling customers to compare retailers' market offers. We considered that the AER's initial DMO (DMO 1) struck an appropriate balance between 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.

Introducing a regulated price carries significant risks to the efficient operation of a market from regulatory error. If the DMO price is set too high, then we would expect more intense competition will compete away any excess margin over time. On the other hand, if the DMO price is too low, then this will more likely negatively impact competition.

The Australian Energy Market Commission's (AEMC) analysis into the customer and competition impacts of the DMO highlighted the potential risks of setting regulated prices too low.¹ The AEMC noted that it could be expected that where a default offer is set below a retailer's standing offer, retailers may attempt to recover lost revenue by withdrawing the lowest price offers from the market. As a result, this creates a risk of convergence to the regulated price. We note for example that initial observations of the operation of the Victorian VDO has been that churn is decreasing and retailer discounts are showing signs of converging around the VDO.

The AEMC also noted that there was likely to be three major long-term effects of re-regulation being: 1) increased risk to retailers driving higher financing and overall costs; 2) lower levels of innovation leading to less available products and services; and 3) higher barriers to entry and changes to consumer behaviour resulting in decreased competition.²

¹ AEMC, Customer and competition impacts of a default offer, Final report, 20 December 2018.

² Ibid,

While the impact of DMO 1 has yet to be fully realised, we agree with the AER that preliminary observations appear to indicate that DMO 1 is achieving its intended objectives. In particular, the recent Australian Competition and Consumer Commission (ACCC) Inquiry into the National Electricity Market Report indicates that:

- prices for standing offer customers have fallen;
- market offers continue to provide opportunities for a better deal; and
- customers are better able to identify cheaper plans with retailers no longer advertising discounts based on inflated and inconsistent base rates and retailers moving away from conditional discounts.³

We also note that there is no evidence of a marked retailer withdrawal from the impacted distribution.

With respect to the DMO to apply to 2020-21, Origin supports the basic indexing approach (option 1) proposed by the AER. We believe this method represents a pragmatic and relatively straight-forward approach and is consistent with the policy objectives for the DMO of providing an appropriate safety net price for disengaged customers whilst also supporting retail competition. In determining the DMO cost stack, we believe that the AER needs to be cognisant of the potential risks to competition and especially around ensuring customers are not dissuaded from being engaged with the market because of a compression of prices.

Origin's response to the questions raised in the AER's Position Paper are set out below

Question 1: For our DMO 2 price determination, do you agree with our proposed approach of carrying forward the DMO 1 price whilst taking into account the changes in forecast changes in input costs?

The AER nominated three potential options for its DMO 2 price determination:

- option 1 – adjusting the DMO 1 price to reflect forecast changes in retailers' input costs by:
 - a) adjusting the environmental, wholesale and network components of the retail bill 'cost stack' to take into account the forecast changes for the 2020-21 period; and
 - b) updating the residual costs (including retail costs) in line with changes to the cost of inflation.
- option 2 – similar to the DMO 1 determination, involves establishing criteria to determine a new DMO price in relation to observed market offers (for instance, at a fixed percentage above the median market offer); and
- option 3 – using a cost based 'bottom up' approach of determining the forecast efficient cost of each component of the retail cost stack, with an added allowance for retail costs and competition. Analysis is then undertaken to determine how far above efficient costs the AER should set the DMO price.

The AER states that its preferred approach to determining the price for DMO 2 is option 1, noting that the DMO 1 appears to be operating as intended and therefore represents an appropriate starting point for DMO 2. The AER notes the significant regulatory reform occurring in the retail market and suggests that a relatively simple approach to the development of DMO 2 such as option 1 will provide a degree of regulatory stability while the new rules are bedding in. Origin appreciates the AER's consideration of the current regulatory environment and agrees that adopting a consistent approach for DMO 2 is prudent. A change in methodology would also raise the risk of a step change in pricing outcomes i.e. moving from one method (i.e. "top-down") to another (cost-based "bottom up").

Origin agrees with the AER that options 2 and 3 do not represent viable alternatives at this stage.

Under option 2, observed market offer prices would be used to derive a benchmark(s). The AER would then set the DMO price at a set percentage above a suitable proxy for the efficient costs of supply (e.g.

³ ACCC *Inquiry into the National Electricity Market—August 2019 Report*, September 2019.

median market offer). Origin agrees that there are challenges in calculating a reliable annual DMO price using market offers. In addition, there are other factors impacting market offers (other than costs) such as promotional offers at various times in the year to attract customers. These prices are intended to attract new customers and do not necessarily reflect a sustainable price to maintain customers, rather they reflect retailers' marketing strategies at a point in time and may not have a substantial uptake. Accordingly, market offers may not provide a representative indication of retailer costs at any point in time.

Option 3 involves constructing estimates of efficient costs incurred by a retailer by conducting a bottom up cost assessment. Origin considers that a bottom-up estimate is a complex exercise and, as noted by the AER, is inconsistent with objectives of a DMO. Specifically, the DMO is not seeking to reflect efficient costs. Rather the DMO is intended as a safety net for disengaged customers and is set at a level that promotes competition in the market. Origin notes the difficulties experienced in other jurisdictions in determining appropriate methodologies and data sets used to develop cost estimates. This is highlighted by the diversity of cost estimates developed by various parties including, for example, the ACCC, Essential Services Commission (ESC) and Independent Competition and Regulatory Commission (ICRC). We note also that option 3 requires an appropriate DMO to be determined from the efficient cost stack, further complicating the option.

In Origin's view, option 1 represents a pragmatic and relatively straight-forward approach and is consistent with the approach adopted for DMO 1. We agree with the AER that option 1 is consistent with the policy objectives for the DMO. Given that DMO 2 uses DMO 1 as a starting point, we anticipate that the relativities in DMO 1 are likely to be maintained under option 1, providing an appropriate safety net price for disengaged customers whilst also supporting retail competition.

However, we note there is an inherent problem with back-casting to determine the input prices for DMO 1. In particular, there is a risk that the back-casting exercise will result in an under/over-weighting of the individual cost components in the DMO 1 cost stack. Given that each cost component is forecast forward at different rates depending on the forecast change in the cost component going forward, any miscalculation of DMO 1 costs impacts DMO 2.

For these reasons, the AER ought to adopt a conservative approach to minimise the risk of regulatory error.

Question 2: Do you consider there is an alternative methodology to determine DMO 2 that better meets our policy objectives?

As noted above, in the circumstances, we support the AER adopting its proposed option 1.

Question 3: Does our representative retailer broadly reflect retailers in each of the markets the DMO will apply?

The AER suggests that a representative retailer is "...an efficient, prudent and risk adverse retailer with an established customer load." Origin considers this to be an appropriate characterisation of the representative retailer.

Question 4: Do you consider there is merit in considering a more simplified forecasting methodology, such as the contract portfolio index, in future DMO pricing decisions? (As outlined in the ACIL Allen Consulting report)

The AER's consultant, ACIL Allen Consulting (ACIL) proposes the possible introduction of a simplified approach to developing the wholesale energy cost (WEC) for future DMO determinations relying on the movement in the portfolio of contract prices from one determination year to the next. ACIL proposes the detailed market-based approach for estimating the WEC be considered for the next three years, followed by the contract portfolio index approach thereafter.

In principle, Origin is not opposed to the development of a simplified forecasting methodology. However, we consider it is necessary to monitor the effectiveness of the current method against its objectives over a number of periods before considering alternative approaches.

Question 5: Do you consider the use of the NSLP and CLP is an appropriate proxy to model a representative retailer's load profile?

In determining WEC, ACIL uses the net system load profiles (NSLPs) and controlled load profiles (CLPs) in for each distribution area. The AER notes that there is limited value in separating the NSLP into residential and small business customer profiles given the wide variety of customers.

Contrary to the AER, Origin considers it important that load data for residential and small business customers is separated. We consider that using a combined load profile does not adequately reflect the variance between maximum and average usage for residential customers. The aggregate of small business and residential profiles also creates a flatter profile than either segment individually, i.e. the analysis only represents the demand for a retailer that holds a balanced small business/residential customer portfolio. We consider that the use of separate load profiles provides a more cost reflective outcome. Origin would be pleased to provide the AER with the associated load profile data if required.

Question 6: Do you consider the proposed hedging strategy is appropriate?

The AER indicates that the representative retailer is presumed to implement a simple hedging requirement and approach. In summary:

- the approach assumes that a prudent and efficient retailer will completely hedge its forecast customer load prior to the commencement of the pricing period; and
- it is assumed the hedge book consists of a portfolio of base, peak and cap quarterly contracts. Multiple hedging strategies would be tested by varying the mix of base/peak/cap contracts for each quarter.

In principle Origin is comfortable with AER's proposed hedging strategy. However, we stress that any strategy needs to sufficiently account for volatility and the linkage between high electricity pool prices and high demand.

Question 7: Do you consider there are improvements to the ACIL Allen Consulting's proposed wholesale cost forecast methodology?

Consistent with the proposed ACIL Allen methodology, Origin considers it vital that the forecast methodology incorporates a sufficiently large data set in order to capture the probabilistic nature of weather events and the impact on spot prices and retailers' wholesale purchase costs.

In addition, it is important that the load profile analysis takes into account the increasing level of behind the meter technology, such as rooftop solar PV. The significant increase in solar PV systems requires the collective trend to be included in future projections. Without the inclusion of this data, daytime load projections will be significantly overstated. Importantly, the cost of hedging is likely to increase as the load factor deteriorates with retailers bearing more under/over hedging as flat swap products are used to hedge a more sculpted load shape.

Question 8: Do you consider there are improvements to the ACIL Allen Consulting's proposed environmental cost forecast methodology?

Origin considers it important to recognise that retailers acquire LGCs 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 AER 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.

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 Clean Energy Regulator (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). We suggest the AER consults with the CER to better estimate a revised STP for inclusion in the AER's draft determination. Further, as the calendar 2020 STP is also relevant to this determination, we suggest that the AER also consider the CER's current non-binding STP.

Question 9: Are the proposed tariffs appropriate for assessing network cost changes?

The AER considers that the representative retailer will pass through network costs through the applicable network tariff to the customer. The AER nominates the relevant non-TOU network tariffs to apply for each customer type in each distribution region.

The AER notes that, due to timing issues associated with approval of annual network tariffs, actual changes in annual tariffs may not be available in time for inclusion in the DMO calculation. The AER notes that the best available alternative forecast is the annual change in revenue provided in the AER's network revenue determinations. The AER therefore propose to use the change in annual revenue to estimate changes in distribution use of system (DUOS), transmission use of system (TUOS) and alternative control services (ACS) costs. The forecast network cost change will then be applied to the relevant network tariffs.

Origin considers that changes in approved network tariffs are suitable for determining the associated change in network costs. Where approved tariffs are unavailable, the use of changes to annual revenue represents an appropriate alternative. However, where the AER uses changes in annual revenue, it is important that any difference between the approved revenue and the eventual network tariffs is also incorporated in the DMO calculation. It may be necessary, for example, for the AER to incorporate a mechanism to true-up any difference between forecast and actual changes to annual tariffs as a result of using network revenue as a proxy e.g. due to variances in demand.

Question 10: Do stakeholders have additional information we should consider in relation to the proposed adjustments to the residual costs?

The AER indicates that it intends to index residual costs by the Consumer Price Index (CPI). Origin agrees with the AER that CPI indexation is appropriate at this point in time.

Question 11: Do you consider our step change framework is appropriate?

Origin considers the step change framework proposed by the AER is a pragmatic means of incorporating exceptional and unavoidable costs that are not captured by the broader DMO calculation. We consider it appropriate that such costs be included in any cost assessment.

Origin considers that the proposed step change criteria is appropriate. However, we would appreciate clarification in terms of:

- the intended materiality threshold applied by the AER in assessing potential step change events;
- the process for determining costs associated with the event; and
- the proposed treatment of multiple regulatory events occurring in a given year. For example, it may be the case that there are a number of events in a given year that, in isolation, are immaterial, but when combined represent a material cost for retailers,

Question 12: Is there any other information the AER should have regard to when deciding to make a specific adjustment for retail costs?

Following the contestability in metering rule change, retailers have become responsible for the provision of metering services. These costs are captured in a retailer's cost to serve and ultimately recovered from residential customers through a daily supply charge in retail tariffs. As the rollout of smart meters is growing significantly year on year, it is essential that the AER allow for retailers to recover their efficient costs associated with this rollout.

Question 13: Do you agree with our initial assessment of potential step changes?

The AER has undertaken a preliminary assessment of recent regulatory events to determine if the associated costs should be reflected in DMO 2. Specifically, the AER has assessed the following regulatory initiatives:

- Five Minute Settlement;
- Retailer Reliability Obligation; and
- Consumer data rights.

As the AER notes, the AEMC considered that the one-off costs of system changes associated with 5 minute settlements would not be insignificant. The AER expects that an efficient and prudent retailer would already have begun making most of the necessary changes to their operations before the DMO 2 time period. Because of this, the AER does not believe there will be an increase to implementation costs above those forecast for DMO 1, and so do not propose any additional cost allocation for DMO 2.

The AER's decision on DMO1 with regard to 5 minute settlements industry costs stated that at this preparatory stage, it expected these will be primarily associated with market generators and the replacement of meters. In the event that these costs are passed on, the retailer will incur the costs through increased wholesale and/or network costs. Given these costs are already included in its cost forecast, the AER did not propose to further adjust forecast retail costs.

Origin has commenced significant preparatory work to develop system and technology designs. However, the costs of developing, operationalising, and testing systems and software have not been fully realised and we expect the majority of these costs (which we believe will be material) will be incurred in years 2020-21 and 2021-22. Therefore, we believe that the AER ought to formally seek cost data from retailers to ensure that it makes an informed decision regarding the retailer costs associated with delivering 5 minute settlements.

Question 14: What additional information should we consider in relation to the proposed usage assumptions?

The AER proposes to continue to use the annual usage figures for residential and small business customers from its DMO 1 Final Determination. In addition, the AER are also proposing to maintain its previous controlled load usage amounts. The AER suggests that maintaining the previous usage determination provides certainty to retailers and allows stakeholders to more easily compare what is occurring in the electricity market over time.

Origin considers that the current usage calculations for flat rate customers and controlled load remain appropriate and are suitable for application to DMO 2.

The AER also indicated that it considers that the usage assumptions for flat rate customers can be applied to TOU customers. Origin considers that the flat rate per customer usage is appropriate for TOU tariff customers. In addition, we consider that the TOU period usage allocations applied by the AER for DMO 1 are reasonable and can be applied to TOU customers for DMO 2. However, we believe that there are significant differences in the charging structure applied by distribution networks (for example Ausgrid⁴) and those assumed under the DMO. In particular, the network supply charge and metering charge is higher than that assumed under the DMO. As a result, Origin would experience a material revenue shortfall from TOU customers if the AER were to simply apply the flat DMO price to TOU tariffs under the assumed usage profile. This represents a significant issue on certain networks e.g. Ausgrid where a large number of customers are subject to TOU tariffs.

In order to provide a more representative price determination for TOU customers we consider that the AER would need to develop a specific DMO for application to TOU customers. This would need to incorporate the TOU charges applied by distribution networks to ensure that retailers are not materially financially disadvantaged.

As discussed, the DMO is applicable to flat rate and controlled load tariffs and has recently been extended to incorporate time of use and solar-specific offers. The AER indicates that the regulations do not require the AER to determine an annual price and usage for other tariff types, including tariffs with a demand charge. However, we note that a number of distributors have introduced default demand tariffs for residential customers as a means of introducing greater cost-reflectivity to their tariffs. For example, Ausgrid recently introduced demand tariffs as the default assignment for residential and small business new connections and customers on flat tariffs upgrading their meter by customer choice.

Origin considers that the DMO cannot be meaningfully applied to demand tariffs. The application of a demand charge has the potential to cause a significant misalignment between the reference bill and actual customer charges, particularly where a customer's usage coincides with peak demand periods. To the extent that Origin offers the network default demand tariffs to customers it faces both commercial and reputational risk as a result of this misalignment.

Under these circumstances, we have concerns about offering default demand tariffs to customers. Origin anticipates that we would need to apply flat rate tariffs to these customers in order to facilitate comparisons to the reference bill. We would then be forced to absorb the commercial risk associated with the difference between network charging (based on demand tariffs) and retail charging (based on the flat rate tariff).

In order to facilitate the introduction of demand tariffs the AER would need to develop a separate DMO for demand tariffs incorporating both usage and demand estimates.

⁴ We note that Ausgrid has a significant number of customers on TOU tariffs and the highest number of customers on TOU tariffs of the DMO networks.

Question 15: Are there any other factors that we should consider in applying the usage assumptions outlined in this section?

We believe that the average consumption for a residential customer as used in the DMO consultation paper is representative of actual residential average usage. Furthermore, we believe that the AER should adopt a consistent application of consumption levels in the context of estimating pricing impacts. However, in terms of a small business customer, the range of usage is significant. As a result, applying a consumption benchmark to all customer in this category will be problematic because it is not necessarily representative.

Question 16: Have we appropriately balanced the policy objectives in our proposed approach to assessing a DMO price for time-of-use tariffs?

As discussed above, we consider that the proposed application of flat rate pricing is not appropriate for TOU customers. The proposed application of the flat DMO price and usage profile to TOU tariffs has the potential to adversely impact retailer cost recovery in a material way. The policy objectives for the DMO include allowing retailers to recover efficient costs and not dis-incentivising innovation, competition and market participation. To the extent we are not able to adequately recover costs associated with TOU tariffs, we consider the proposed approach is inconsistent with the DMO objectives.

In order to comply with the DMO objectives we consider that:

- the DMO in its current form needs to provide an allowance for the increased cost associated with the use of TOU tariffs. The allowance could be determined by a thorough review of existing network TOU charges and usage patterns; or
- the AER needs to develop a specific TOU DMO that incorporates representative usage profiles and pricing for TOU customers in each of the distribution zones.

Question 18: Do stakeholders consider the proposed approach would appropriately balance the policy objectives if we are required to determine a DMO price for solar tariffs?

Origin considers that the proposed approach to solar tariffs is consistent with the DMO objectives, Accordingly, we agree with the AER that there is no reason at this time to make fundamental changes to the representative customer determinations to account for the inclusion of solar customers.

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

Yours sincerely



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