



17 March 2021

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Dear Mr Feather

RE: Default Market Offer Prices 2021-22 Draft Determination

Origin Energy appreciates the opportunity to provide a submission in response to the Australian Energy Regulator's (AER) Default Market Offer Prices 2021-22 Draft Determination.

Price regulation carries significant risks to the efficient operation of a market from regulatory error. If regulated businesses are not afforded a reasonable opportunity to recover their efficient costs this will lead to a loss of dynamic efficiency. Over the longer term, under-compensation resulting from regulatory error is likely to reduce competition and stifle innovation; neither of which is in the long-term interests of electricity consumers.

One of the key objectives of the default market offer (DMO) price cap is to allow retailers to recover their efficient costs of providing services, including a reasonable retail margin. We do not believe this objective has been met. Since the introduction of the DMO, the AER has not allowed retailers to recover their efficient costs relating to: the re-balancing of SRES costs in DMO 1; under-recovery of network charges in DMO 2; smart metering costs for DMO customers; and COVID-related debt costs.

In assessing these costs, the AER has considered whether these costs ought to be recovered as part of a retailer's normal costs or whether they meet the criteria for a step change adjustment – that is a cost due to an exogenous change in a retailer's operating environment that leads to a material overall change in overall costs.

The AER has taken the position that 'the DMO price is sufficiently high that minor cost increases can be accommodated without impacting retailers' abilities to recover their costs to service standing offer customers'.

The AER has not defined either "sufficient" or "material".

As a result, there is no objective assessment framework against which the AER will assess an application for a change in costs. Objectivity and certainty are fundamental to reduce regulatory risk in any regulatory framework.

Furthermore, the AER does not correctly distinguish between controllable and uncontrollable costs. A retailer does not have control over all the cost elements in the DMO. The residual component is effectively the only cost element over which a retailer has control. When the AER suggests that some costs are not "material" in the context of the DMO, it is using the wrong reference point. The question it needs to ask is whether the cost is material relative to a retailer's controllable costs – that is relative to the residual.

We have provided below additional commentary on these and other matters contained in the AER's draft decision.

Efficient Costs

The *Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019 (Regulations)* sets out the legislative framework for the DMO. The Regulations require the AER to have regard to a range of specific factors including wholesale electricity, network and retail costs and the principle that a retailer should be able to make a reasonable profit.

The AER considers that the median market offer price is a reasonable indication of retailers' efficient costs to serve customers in each region (presumably including a reasonable profit). The AER also states that its draft DMO3 remains well above median market offer prices indicating that retailers can recover costs for serving customers while also having incentives to compete on price and offer discounts.

The AER has deferred to this rationale in rejecting retailer requests for the inclusion of costs in relation to:

- smart metering for DMO customers;¹
- servicing TOU and solar customers;²
- COVID-19 related bad debts;³
- the difference between the indicative network tariffs used for the DMO 2 determination and the final approved network tariffs;⁴ and
- rebasing of the SRES index for DMO2.

Origin estimates the costs incurred by Origin alone associated with these activities and events to be in excess of █████. Origin has provided the AER with details of these costs in previous submissions but would be happy to provide additional details should the AER request.

The AER assert that the DMO price is "sufficiently" above efficient costs to accommodate these additional cost imposts and no further allowance is required in the DMO. Asserting that competition remains robust or that market offers are above the DMO price and therefore the DMO must be set above the efficient level is a simplistic assessment of the impact of these costs on retailers. There are a variety of reasons for retailers to provide discounted market offers, including to gain market share. These offers are invariably unsustainable and are not indicative of a retailer's underlying operating costs, including costs associated with ongoing investment in technology and systems that are necessary for retailers to be competitive in the long term. The AER's comparison is also to the unweighted median of prices – it is not clear what analysis the AER has undertaken to determine the amount of revenue retailers receive from these underlying plans.

Further, the AER provides no assessment of what it considers to be "sufficiently" above efficient costs. We question at what level the AER considers the DMO will no longer be sufficient to accommodate costs and request that the AER provide guidance in this regard. We consider that the AER's continued reliance on this measure to assess cost imposts and as a means of determining a retailer's efficient costs is inappropriate and runs the risk it will eventually reduce retail margins to such an extent that retailers disengage from the DMO or result in retailer failure. It would be an undesirable outcome to see an increasing number of market offers that exceed the DMO.

¹ AER, 2021, Default Market Offer Prices 2021-22, Draft Determination, February, p.88.

² Ibid., p.80.

³ Ibid., p.61.

⁴ Ibid., p.30.

The AER has previously indicated that an over-riding policy objective of the DMO is to allow retailers to make a reasonable retail margin and not dis-incentivise competition, innovation and participation. The goal is not to drive cost allowances to an unsustainable level or deny retailers an appropriate profit margin. Doing so may appear to have short-term benefits for customers but the longer-term impacts can be harmful to all market participants. Our view is that the AER's failure to adequately compensate for legitimate costs incurred by retailers erodes the effectiveness of the DMO and has potential longer-term impacts including reduced competition, a narrowing of market offers and acts as a disincentive to innovation.

While we appreciate that the DMO is not based on a bottom-up assessment of costs, we expect additional cost imposts to be assessed on their merit and provided for as appropriate. We consider it is possible for the AER to make allowance for legitimate costs in the DMO whilst still achieving the policy objectives of the DMO. Indeed, we consider it is incumbent on the AER to do so in the interest of good regulatory practice and the continuation of a healthy retail sector – failure to make adequate allowance for legitimate costs impacts all retailers but is likely to have a disproportionate impact on smaller retailers, with long terms implications for competition in the sector. Accordingly, we request that the AER adopt a structured and transparent approach that assesses additional cost imposts on their merits and provides for the appropriate recovery of genuine costs incurred by retailers.

Materiality

The DMO calculation provides a step change assessment framework that allows for the pass through of any additional material cost changes to an efficient and prudent retailer's cost of supply expected to be incurred during the determination period. Analysis of potential step changes requires an assessment of three fundamental conditions:

- is the event uncontrollable/exogenous?
- have the costs been incorporated elsewhere in the DMO allowance? and
- are the associated costs material?

The first two conditions are reasonably straightforward to determine. However, in relation to the materiality of costs, the AER notes that:

While we have not defined 'materiality' in this context, our intention is that incremental and minor cost changes would not meet the criteria for consideration. The DMO price is sufficiently high that costs of this nature will not impact on retailers' ability to recover their costs to service standing offer customers, and do not require a specific adjustment.⁵

The AER does not define the terms "materiality", "incremental" and "minor" or explain their application. Rather, the AER has taken a non-transparent approach to assessing the requirement for costs to be incorporated in the DMO based on a rudimentary comparison of the DMO with unweighted market offer prices. Origin considers there is a balance to be struck between providing retailers with legitimate costs whilst still maintaining the DMO policy objectives; the two goals are not inconsistent and can be achieved in a variety of ways. The continuous erosion of the residual is a denial of legitimate costs on the basis that "sufficient" headroom already exists in the DMO. Markets observations of this nature provide only limited insight into a retailer's efficient costs or their actual revenues and should not be taken as the only measure of the financial health of the retail sector.

The current AER framework for cost assessment is subjective and provides retailers with no guidance on the process or any potential recourse. At a minimum, Origin requests an agreed definition of "materiality", "sufficient", "incremental" and "minor" cost changes.

⁵ AER, 2020, Default Market Offer Prices 2021-22, Position Paper, October, p.41.

By way of comparison, the materiality threshold applied to network businesses with respect to cost pass-through applications is defined as:⁶

For the purposes of the application of clause 6.6.1, an event results in a DNSP incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the DNSP has incurred and is likely to incur in any regulatory year of a regulatory control period, as a result of that event, exceeds 1% of the annual revenue requirement for the DNSP for that regulatory year.⁷

Whilst not necessarily comparable to the DMO process, the identification of a specified materiality threshold provides an objective measure against which to assess the impact of the pass-through event on a DNSP, whilst limiting vexatious claims. Furthermore, we consider that any materiality threshold must be applied to a retailer's controllable costs, not to the DMO as a whole. We consider that the AER current assessment of costs for inclusion in the DMO will benefit greatly through the application of a similar process.

ACCC Cost Stack

Each year the ACCC's Electricity Monitoring Inquiry publishes information about retailers' costs. The AER states that it does not have ready access to the ACCC's disaggregated cost stack data and therefore it cannot measure capital costs and total costs associated with electricity retail operation. If a lack of access to this information is impeding the AER's ability to make properly informed decisions, the AER should request that the information be disclosed to the AER pursuant to s 157A of the *Competition and Consumer Act 2010* (Cth).

Based on Origin latest submission to the ACCC, our retail and other costs are ██████ or ██████ per customer and our EBITDA is ██████ or ██████ per customer. Compared to the costs the AER has not allowed for, we think there is a strong case that ██████ (approximately ██████ per customer) is material.

Network Costs

The AER states that if it has approved the 2020-21 network pricing proposals at the time of finalising the DMO calculations in late April 2021, it will be straightforward to use the final published prices. If the AER has not approved the prices, it states that it will use the submitted network prices, noting these may change before they are finally approved. The AER states it still considers this is the best alternative to approved tariffs.

However, if the pricing proposals are delayed by the network businesses, or they are undergoing AER assessment at the time of the DMO3 Final Determination, the AER states it will have regard to the latest available indicative network tariffs.

On the one hand the AER states that if it has not approved the network prices, it will use the submitted network prices, noting these may change before they are finally approved. However, the AER then states that if the pricing proposals "are undergoing AER assessment" at the time of the final determination it will revert to using the indicative tariffs. But if the prices have been submitted but not yet approved, aren't they by definition "undergoing AER assessment"? We seek clarity regarding what circumstance the AER would actually rely on the submitted but not-yet approved pricing proposals?

In the DMO2 decision, the AER used 12-month-old tariffs as the best available information. This resulted in a material shortfall in the recovery of network costs for Origin. Our position is that in the absence of approved network prices, the AER ought to use the proposed network tariffs for 2021/22 as included in the network tariff proposals for 2021/22.

⁶ National Electricity Rules Version 159, Chapter 10, Glossary.

⁷ National Electricity Rules Version 159, p. 1303.

Cost to Serve SAPN CL Customers

All regions have a residual component for residential controlled load (CL) of about 20 per cent, except SAPN where this is about 10 per cent. In the SAPN network, the DMO allows for less residual component for a 6 MWh customer (on a flat rate tariff with controlled load) than it does for a 4 MWh customer (on flat rate tariff) with the residual component for a customer on flat tariff being \$277 compared to only \$235 for a customer using more energy on flat tariff with controlled load. We would appreciate the AER providing an explanation for this divergence in costs.

COVID Costs

We believe the AER ought to closely consider the relationship between its Statement of Expectations (SoE) and COVID-related debt costs.

The SoE places certain obligations on retailers with respect to disconnection of a customer for debt. That is a retailer must not disconnect a customer who is in contact with their retailer regarding their debt. However, this contact can be minimal and limited in terms of working with the customer to manage their debt. Customers are more likely to contact their retailer once they receive a notice of disconnection and to continue this engagement on an ongoing basis. This produces higher rates of customer engagement among those that have received disconnection notices.

Therefore, the policy to prevent a disconnection notice being issued has the impact of increasing debt. If there is a policy that imposes restraints on a retailer's operations which increases costs, then this ought to be accounted for as an uncontrollable cost to the retailer.

Furthermore, the AER has noted that based on the publicly available information provided, estimated bad debt increases range from around \$4 to \$10 per customer for the current year. The AER also noted that while it recognises the increases in bad debt costs may be higher than the CPI rate of change adjustment, it is satisfied the DMO price is sufficiently above retailers' efficient costs, that the DMO policy objectives will continue to be met without making an adjustment for COVID-19.

As noted above, when compared to Origin's retail operating costs per customers, COVID-related debt costs alone are of the order of █ per cent. In any other regulated price setting framework, an uncontrollable cost of █ per cent would be considered material.

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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