



4 April 2019

Dr Ron Ben-David
Chairperson
Essential Services Commission
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Email: RetailEnergyReview@esc.vic.gov.au

Dear Dr Ben-David

RE: VICTORIAN DEFAULT OFFER DRAFT ADVICE

Origin Energy appreciates the opportunity to provide a submission in response to the Essential Services Commission's Draft Advice on the methodology and price for the Victorian Default Offer.

It is vitally important that the Essential Services Commission (ESC) ensures that its method and price does not produce outcomes that harm the competitiveness of the retail market and limit the ability of active customers to obtain the rewards they otherwise would.

The *Independent Review of the Electricity & Gas Retail Markets in Victoria* (Thwaites Review) made a number of reform recommendations aimed at achieving the objective to make Victoria's retail energy markets fair. The Government considers that the deregulated energy market is not working effectively and accepted the Thwaites Review recommendations, including replacing standing offers with a fair price for energy.

We recognise that the ESC is bound by its terms of reference. However, this should not preclude the ESC from providing frank advice to the Government about the risks of the Government's preferred approach to price controls including how these could better complement the broader package of reforms.

The Thwaites Review considers two broad reform paths: customer engagement and protection; and the imposition of price controls.

The consumer engagement and protection reforms are intended to enhance competition by empowering customers and imposing conditions on the market to work more effectively. These include measures which make switching easy and attractive to undertake, encouraging innovation from smart meter data, and supporting vulnerable customers.

The use of customer engagement measures has a substantial advantage over price controls. If successful, they take the market to the point where most regulators (and policy makers) want it to end up; in a state of effective competition, where the combination of productive, allocative and dynamic efficiency is within reach. Therefore, they ought to carry primacy in any reform package.

The introduction of price controls via the Victorian Default Offer (VDO) will reinforce disengagement which is one of the key market problems. The VDO will have an impact on retailers' incentives to compete to acquire customers, as well as on customers' incentives to engage with the market. This, in turn, may lead to price convergence around the VDO and the removal of the lowest discount offers from the market. To be successful, customer engagement and price reforms need to be mutually reinforcing.

A key precondition to achieve this outcome is for the VDO to be set low enough to provide a reasonably priced safeguard option but also at a level that still supports the development and maintenance of competition. The VDO needs to be set at a level that will allow efficient retailers to compete beneath the level of the VDO while still earning a normal return on capital (through the inclusion of headroom and the selection of appropriate cost benchmarks).

The ESC has set a draft VDO that represents around a 25 per cent reduction on the median of existing standing offer prices. This is a material reduction and is likely to have unintended consequences on the competitiveness of the market. By way of comparison, the AER's Default Market Offer (DMO) represents around an 8 per cent reduction.

In its advice to the COAG Energy Council on the customer and competition impacts of the DMO, the AEMC noted that retailers use market segmentation to compete. Where a regulated price is set below a retailer's standing offer, the retailer will seek to offset these losses by reducing the level of discount available on market offers. The AEMC noted that the impact is uncertain but nevertheless modelled a range of scenarios.

The AEMC's analysis revealed that in NSW, a default offer set 10 per cent below the current average standing offer could result in a 23.6 per cent increase in the lowest market offer bills. In South Australia, a default offer set 10 per cent below the current standing offer price would increase the lowest market offers by 25.8 per cent. If the level of the default offer in South East Queensland is set at 10 per cent below the current average standing offer, the only way for retailers to recover 50 per cent of their revenue shortfall would be to set market offers above the default offer. This is clearly not a feasible outcome, but does illustrate the potential detrimental implications for retail competition if the default offer is set too low.¹

We believe the ESC ought to conduct similar sensitivity analysis as part of its advice to Government; and in particular how retailers can profitably service customers at the VDO level. This advice could shape the terms of reference for future determinations by the ESC.

We also recognise that the ESC is subject to timeframes that restrict its ability to undertake the level of detailed analysis it may otherwise pursue. As a result, it has drawn guidance from external reviews, namely the ACCC's Retail Electricity Price Inquiry.

While we consider this approach pragmatic in the circumstances, to recognise the inherent risk in a compressed regulatory process (for example compared to the procedural fairness afforded to electricity distribution networks under the AER framework), the ESC must take a conservative approach, especially when relying on the analysis of other agencies when the purpose of this alternative analysis was to guide policy and regulatory reform rather than for a detailed regulatory price determination.

Adopting a conservative approach to costs would go some way to balancing the need to determine a reasonably priced option for disengaged consumers with one that does not harm competition and penalise engaged consumers.

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 response to specific issues in the ESC's draft advice is set out below.

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

Wholesale Costs

Frontier Economics (the ESC's consultant) has based its calculation of energy purchase costs on an efficient benchmark retailer. We agree in principle that an efficient retailer will make use of exchange traded financial derivatives to hedge its exposure to spot prices to minimise its financial risk.

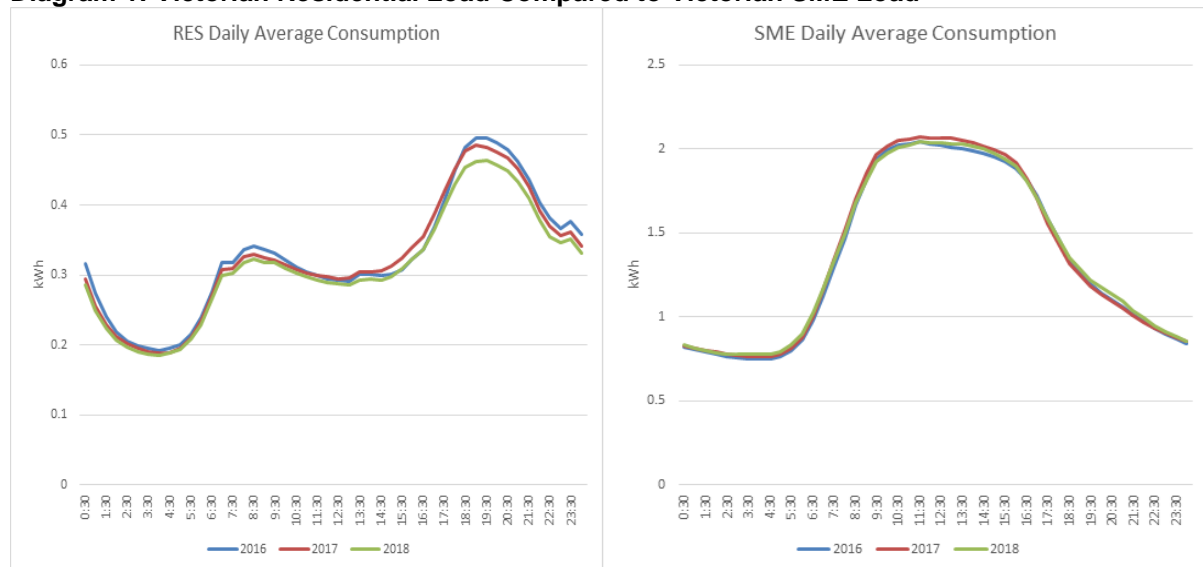
However, the ability to develop a prudent hedging position is especially sensitive to the load profile used for this analysis.

Frontier has used 5 years (2012 to 2017) of Manually Read Interval Meter (MRIM) data from AEMO from each distribution zone to establish the likely half-hourly load of the retailer's customers. It also takes the corresponding half-hourly spot prices for the 5-year MRIM data.

This data records consumption of less than 160MWh, however, it does not separate load data for residential and business customers. As a result, Frontier has used a load profile that does not adequately reflect the variance between maximum and average usage for customers using less than 40MWh and especially the residential cohort. The aggregate of SME 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 SME/residential customer portfolio.

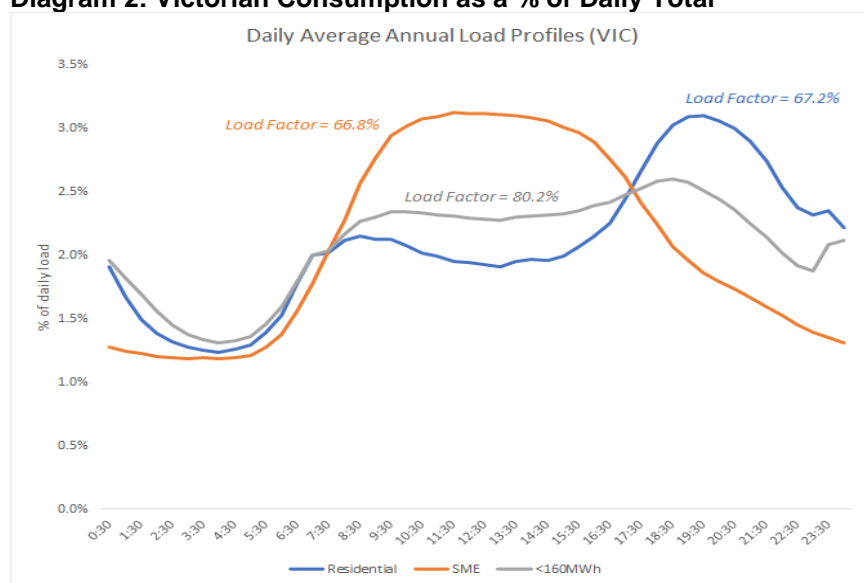
To highlight this issue, we have developed a number of load profiles for residential customers and SME customers. These are presented in diagrams 1 and 2.

Diagram 1: Victorian Residential Load Compared to Victorian SME Load



Source: Origin analysis

Diagram 2: Victorian Consumption as a % of Daily Total



Source: Origin analysis

The shape of the assumed load is a key driver of costs. Specifically, the flatter the load, the hedging strategy will be able to adopt an optimal position using more base load swaps and less exposure to peak swaps and spot prices. The greater variance between average load and peak load means that the optimal strategy will involve a greater proportion of peak swaps and caps. This is ultimately a higher cost strategy.

As the above diagrams demonstrate, the load profiles for residential customers exhibit a peakier profile than the MRIM 160MWh profile. For this reason, we disagree with Frontier that the differences between the MRIM data and the actual load profile for 40MWh is relatively small.

Given the implications, we consider that the ESC needs to ensure that its calculation of efficient contracting options reflects the most accurate load profile. We would be happy to provide the ESC with additional data to make necessary adjustments.

In terms of the optimal set of efficient contracting options, we consider that the ESC should provide a detailed breakdown of the mix of hedging products and their commensurate costs to enable stakeholders to provide more informed comments.

To better align its prices with the market's view on what will be the average spot price for 2019-20, Frontier assume that its average prices will be consistent with ASXEnergy futures prices. To do this, Frontier scale its half-hourly prices so that the time weighted average price in each quarter is equal to the relevant quarterly base swap prices for 2019-20 from ASXEnergy. However, the afternoon peak is a lot higher relative to average in the <40MWh than the <160MWh and, as result, the load weighted cost on these customers is higher. We do not believe Frontier's analysis has accurately captured this

Volatility Allowance

The ESC has included a volatility allowance which is intended to compensate retailers for the residual risk to which they are exposed, even when it contracts at the conservative point. The allowance is calculated based on the cost of holding working capital to fund cashflow shortfalls that could arise in years when the actual wholesale energy costs are higher than the Frontier estimate for the median simulated year.

The working capital requirement is based on the difference between the wholesale energy cost estimated for the median simulated year and the wholesale energy costs for the costliest simulated year for each distribution area.

We consider that the volatility allowance understates the level of risk costs associated with Frontier's expected exposure. Specifically, Frontier appear to suggest that a 15c/MWh premium accounts for all remaining wholesale volatility risk. We believe that it is unlikely that a retailer could secure from the market a risk product (e.g. load following hedge) that managed all volatility risk for a 0.15 per cent premium. By way of comparison, the price of swaps for a given period varies by more than this every day.

For these reason, we consider that the ESC ought to reassess the cost of managing residual risk under its preferred approach to developing wholesale costs.

Timing Differences

The ESC has taken an annualised view of costs. With respect to wholesale costs this has involved taking Q3 and Q4 for Cal19 and Q1 and Q2 for Cal20. However, Origin (and we believe other retailers) establish its retail prices on a calendar year basis. That is, for 2019, the price reflects the forecast costs over all quarters for Cal19. In doing so, we smooth fluctuations in prices across the quarters to translate these into a fixed retail price for the year.

However, the VDO that will take effect from 1 July 2019 does not include the costs incurred by retailers for Cal19 Q1 and Q2; rather it is forward looking and includes Cal20 Q1 and Q2.

Not only does this approach not capture the timing differences with respect to how retailers develop calendar year prices, it is unclear how Cal20 Q1 and Q2 prices will be considered for the 1 January 2020 VDO when they have already been incorporated into the 2019 VDO.

Our preferred position is that the VDO to take effect on 1 July 2019 should be derived based on Cal19 Q1 and Q2 prices and the VDO to take effect from 1 January 2020 should include Cal20 Q1 and Q2 prices.

Environmental Scheme Costs

The ESC has taken the position that the cost to a retailer of obtaining LGCs can be determined either on the basis of the resources costs associated with creating LGCs, or on the basis of the market price which LGCs are traded. For the purposes of the VDO, the ESC used a market price for LGCs to determine the cost of complying with the LRET. The market price for LGCs is determined by taking a 40-day average of LGC prices as reported by Mercari.

Origin supports the ESC's decision with respect to wholesale costs to adopt a 12-month average of the ASXEnergy contract prices for quarterly base swap prices (up to 15 February 2019) as representing the market's current view of spot prices for each quarter of 2019-20. We believe that a consistent averaging period should also apply to environmental scheme costs.

We also note since the ESC's report, the AER has updated its forecast for the Small-scale Technology Percentage (STP). It is now 21.73 per cent for 2019. The ESC should update its analysis accordingly.

Retail Costs

The ESC has largely taken guidance from the ACCC REPI in determining retail operating costs.

The ACCC found that on average that retail operating costs across the jurisdictions with competition ranged from \$81 per customer in South Australia to \$100 per customer in SEQ. It noted that the retail operating costs in Victoria were \$92 per customer.

Frontier found that recent regulatory decisions had provided an allowance for retail operating costs of between \$122-\$129 per customer. Frontier also looked at Origin's and AGL's annual reports over the period 2012 to 2018. Frontier found that operating costs were:

- AGL \$64-\$84 per customer; and
- Origin \$119-\$168 per customer.

The most recent data (2017-18) was: AGL \$84 per customer; and Origin \$126 per customer.

The ESC considered that retail competition to date has driven efficiencies and therefore consider earlier regulatory benchmarks should not be adopted. On the basis that the ESC considered that it would be unreasonable to assume that the marginal customer would be serviced by a retailer with costs notably higher than the average, the ESC has taken the ACCC Victorian average for ROC as a starting point and then added a 5 per cent buffer. This resulted in a retail operating cost allowance of \$104.50 per customer.

As we indicated in our previous submission, the ACCC did not include a category of 'other costs' that some retailers reported in their data submission for years 2013-14, 2014-15 and 2015-16. Because the ACCC express retail operating costs as an average, it is difficult to determine to what degree 'other costs' have been included.

In the case of Origin, a significant portion of our retail operating costs are in the "other costs" category.

Origin considers that it has one of the lowest retail operating costs per customer in the market; yet our reported costs are well above the ACCC average (perhaps due to the exclusion of 'other costs'). Conversely, AGL's lowest bound operating costs are over 30 per cent lower than the ESC's regulatory allowance.

We believe that this highlights that there are imperfections in how the ACCC has used its data and how it has derived average costs. Given the variances in results, it is essential that the ESC obtains a clear understanding of how the ACCC has derived its average and why this departs so significantly from the publicly reported costs of retailers. To assist the ESC in this regard we have provided a confidential break down of our operating costs including detailed costs provided to the ACCC at Attachment A.

Failure to ensure that the ACCC cost data is accurate would prohibit retailers from being able to reasonably recover their efficient costs.

Finally, we understand that the ESC has not factored in the future Retail Reliability Obligation (RRO) that commences from July 2019. These obligations have the potential for retailers to adopt a higher hedge position to meet their RRO obligations and these need to be adequately reflected in retailers' costs.

Retail Operating Margin

The ESC has stated that the objective of the retail operating margin is to compensate the investor for the capital invested in the business and for the non-diversifiable risks associated with the investment. Compensation for discrete risks that can be quantified should be included in relevant components of the cost stack.

Unlike network regulation, the ESC does not have access to retailer asset values and detailed costs. Therefore, it cannot undertake a bottom up analysis using these asset and cost inputs and a derived weighted average cost of capital (WACC).

As an alternative, the ESC proposed to undertake both a benchmark analysis of previous retail regulatory decisions and an expected returns calculation.

A key variable of the expected return calculation is the derivation of a benchmark WACC. To set the WACC at a value that reflects the market risk of electricity retailers is a complex task. The AER has recently undertaken an extensive process to review its Rate of Return Guidelines for regulated network businesses. This review took the better part of 18 months to complete. Furthermore, network WACC parameters have been tested on numerous occasions through the Australian Competition Tribunal and the Federal Court. Despite such scrutiny and analysis, network WACC decisions remain a contentious issue.

A detailed review of WACC parameters for electricity retail businesses has not been undertaken by Australian regulators. Given the precedent set for network regulation, we believe that it would not be appropriate to adopt the outcomes of an expected return calculation in the absence of such detailed review, analysis, and consultation on the appropriate WACC parameters.

Furthermore, the approach taken to apply a margin assumes an average margin across all customers. We do not believe this is an accurate method. An average assumes that a retailer will achieve a higher margin on some customers and a lower margin on others. By definition, a lower margin is achieved on customer with a discount; that is market customers. The majority of customers in Victoria are market customers.

Therefore, taking an average margin results in a bias toward a competitive margin. We believe the ESC ought to take the higher end of IPART's range to reflect the fact that different market offerings deliver different ranges of margin. Taking an upper end allows a retailer with a reasonable opportunity to recover their efficient costs.

Given the increase in market risk (e.g. wholesale volatility) and regulatory risk since the previous regulatory decisions, and the bias in return to the lower range, we consider that the ESC should adopt a margin at the higher end of IPART's range and adopt a margin of 6.1 per cent. We believe this provides for a conservative and pragmatic decision.

Other Matters

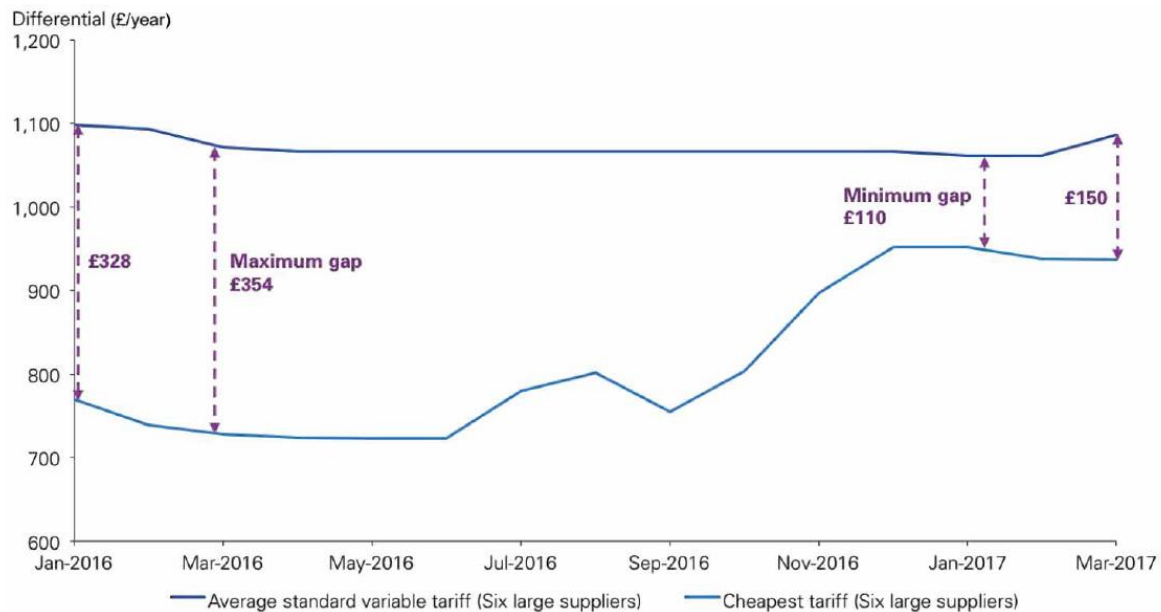
In our previous submission we highlighted that introducing a regulated price carries significant risks to the efficient operation of a market from regulatory error. If the VDO price is set too high, then we would expect more intense competition will compete away any excess margin over time. However, 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 to negatively impact competition.

The ESC's draft advice proposes a VDO that represents round a 26per cent reduction on the median of existing standing offer prices.

As highlighted earlier in this submission, the AEMC's analysis into the customer and competition impacts of the DMO highlighted the potential risks of setting regulated prices too low. 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. The AEMC noted that when price regulation was re-introduced into the United Kingdom, there was a significant reduction in price dispersion. This is best

illustrated in the below diagram from KPMG’s analysis of the impact of re-regulation and price compression

Diagram 3: KPMG Analysis of price change in retail prices in the UK following Price Cap



Source: KPMG, *What would a price cap mean for the UK?*, June 2018, KPMG, London, p. 5.

Note: KPMG analysis based on Ofgem’s retailer price comparison data, 2017.

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.

Given the magnitude of the reduction in standing offers under the VDO, we believe that the ESC 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.

Given the risks identified by the AEMC and the concerns of retailers, we believe it is responsible for the ESC to conduct sensitivity analysis to demonstrate how retailers could profitably serve customers at the proposed VDO levels and what impact the VDO is likely to have on market discounts and prices. This advice should be made available to Government.

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.

If set inefficiently, it will harm competition which may result in disengagement and price convergence around the VDO, while at the same time penalising the most engaged customers.

We consider that the ESC must take a conservative approach to ensure that its decision does not cause harm to the market and result in outcomes that are not in the long-term benefit of customers. In this regard, we believe it is essential that the ESC conduct sensitivity analysis to demonstrate how retailers

could profitably serve customers at the proposed VDO levels and what impact the VDO is likely to have on market discounts and prices

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.

We look forward to working closely and cooperatively to support the ESC in completing its advice to Government.

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".

Keith Robertson
General Manager, Regulatory Policy