12 April 2022

Ms Kate Symons
Chair
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne Victoria 3000

Email: VDO@esc.vic.gov.au

Dear Ms Symons

RE: 2022-23 Victorian Default Offer – Draft Decision

Origin Energy (Origin) appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) draft decision for the 2022-23 Victorian Default Offer (VDO).

We firmly believe that a strong and sustainable regulatory framework is one that strikes a balance between meeting the Government's objective for an affordable and fair price for those customers unable or unwilling to engage in the market and not hindering further development of competition so that those customers who are willing to engage are not disadvantaged.

We support the ESC to continue to review elements of its methodology to ensure that its regulatory decisions allow retailers a reasonable opportunity to recover their efficient costs and to promote competitive market outcomes.

We recognise that the ESC is bound by the Government's pricing order and its own legislation. However, to the extent practicable we urge the ESC to consider the impacts of its decision beyond determining an affordable price today and to consider how the market will evolve over time. The ESC correctly notes that since the introduction of the VDO, retailers continue to enter the market, at least based on the number of licences obtained. While there may be increased numbers of licensed retailers, it appears that few of these retailers are actually active in the market. For these reasons, we consider that the ESC should consider carefully how it defines the term "modest" as provided for in the VDO Order in Council for the allowance of customer acquisition and retention costs as this may have an impact on the long-term effectiveness of competition in the market.

In terms of wholesale costs, we note that there has been considerable spot price volatility over recent months driven by a significant uplift in generation input costs. Given the existing market uncertainty it is vital that retailers have certainty and understanding regarding how the ESC has determined its wholesale cost allowances, especially with respect to how the efficient hedged portfolio has been chosen and how this portfolio aligns with actual contracting options faced by retailers.

Additional commentary on these and other matters contained in the ESC's draft determination is provided below.

Wholesale Costs

Contract position

The ESC uses a futures market method to estimate wholesale electricity costs (WEC) for the VDO. Specifically, the ESC's consultant, Frontier Economics (Frontier), uses historic load data combined with historic Victorian spot price data to forecast a relationship between price and consumption in the wholesale market. Frontier then estimates the hedging position a prudent retailer would adopt using its STRIKE optimisation model. STRIKE calculates an efficient frontier, which represents the contracting positions that provide the lowest energy purchase cost for a given level of risk.

We believe a key requirement from Frontier's modelling is that it reflects market expectations. This is especially relevant as we have significant spot price volatility largely driven by global supply factors which is reflected in a Victorian forward curve that has doubled in value over the last year. It is vital that Frontier's predicative modelling captures how a prudent retailer would have built a hedge book over the previous twelve months when these outcomes and events were unforeseen i.e. absent perfect hindsight. In other words, could any retailer have reasonably built Frontier's proposed portfolio over the last 12 months?

Specifically, if Frontier were to run current prices through its model today would it generate a different portfolio based on that price, especially when the current price is not known a year ago. We seek clarity from the ESC that Frontier's model would generate the same efficient portfolio.

Furthermore, given that the swap level does not significantly impact WEC, the lowest risk portfolios may include a wide range of swap levels and hence a wide range of WECs. This may introduce subjectivity into the resulting hedge levels or mean other modelling artifacts determine the swap hedge level. It is important that we understand how the chosen contracting levels are ultimately selected.

For these reasons, we consider that Frontier should publish the efficient frontier charts with the selected portfolio highlighted and details of any sensitivity analysis conducted.

Furthermore, given the higher than normal spot price volatility, we believe that the ESC ought to consider the inclusion of a risk premium in the calculation of the volatility allowance. Because of this unusual volatility, retailers may be exposed to higher working capital requirements than under the less volatile years since the introduction of the VDO. A risk premium would go some way to funding any higher working capital cost requirements in the current environment and could easily be removed in subsequent decisions when this volatility subsides.

Use of historic data

We support the proposal to base wholesale cost estimates on the most recent three years of electricity demand as a means of reflecting changes to the pattern of demand resulting from increased investment in rooftop solar. In particular, the recent growth in rooftop solar has reduced the demand for other generation during the day. This represents a fundamental shift in the load shape and means that data prior to the emergence of this trend can no longer be relied on as an indicator of future demand. While we prefer a longer data series to smooth fluctuations, the use of representative data is critical for forecasting. We expect the trend in rooftop solar to continue for some time and agree with the ESC that additional data may be added in future years to provide a larger dataset.

Metering costs

The ESC notes that new information suggests that the use of the cheapest meter configuration is likely to understate retailers annual metering costs. The data show that a growing proportion of customers are no longer serviced by the basic meter type, but rather by more sophisticated (and expensive) meter types. Based on this information, the ESC suggests that the average cost of all residential and small business meters, weighted by customer numbers, will more accurately reflect costs. We agree that there are a variety of meter types provided to customers and the cheapest configuration is not indicative of the actual costs faced by retailers. We agree with the ESC that a weighted average approach will provide a more accurate reflection of retailers annual metering costs.

Retail operating costs

The ESC proposes to maintain the current benchmark approach to setting retail operating costs. We are broadly supportive of the benchmark approach but note that retailer obligations are continually changing. These obligations often involve significant system changes and compliance requirements for retailers, resulting in significant cost imposts. It is important that the ESC continue to monitor the regulatory environment facing retailers and ensure that retailers are appropriately compensated for any increase in their obligations.

Customer acquisition and retention costs (CARC)

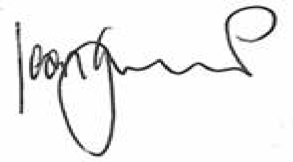
Origin supports the estimation of customer acquisition and retention costs using benchmarking. While the Pricing Order provides for only a modest CARC allowance, basing the allowance on the out-dated NEM-wide average for 2013-14 from the ACCC inquiry final report[1] seems overly conservative given the ESC now has updated data. Further, the ESC acknowledges that retailers' actual CARC costs are above the proposed benchmark but sees no benefit (for customers) in increasing the benchmark.

We consider that the ESC needs to clarify its interpretation of "modest" and how it considers that the current benchmark meets this interpretation. Without a clear understanding of the ESC's considerations in determining the benchmark CARC allowance it is difficult to engage in a constructive debate on the appropriate allowance. That is, without understanding the definition of modest, what benefits the ESC expects from CARC expenditure, and how it measures these, it is difficult for stakeholders to argue for an alternative allowance.

From our perspective, consumers' long-term interests are best served by a CARC that provides a balance between allowing sufficient information to incentivise consumer engagement without imposing excessive costs on disengaged customers. We consider that the ESC should discuss how the current benchmark achieves this balance within the "modest" constraint. We are concerned also that an insufficient CARC allowance may impact the decision for new retailers to enter the market. For example, while a significant number of new retail licences have been granted since the inception of the VDO[2], it does not appear that many of these retailers have entered the market. Increased competition benefits all consumers and should be encouraged and fostered where possible, including through the provision of an appropriate CARC allowance.

If you have any questions regarding this submission, please contact Gary Davies in the first instance at gary.davies@originenergy.com.au.

Yours sincerely



Sean Greenup
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[1] Australian Competition and Consumer Commission (2018), Retail Electricity Pricing Inquiry: Final report, July.
[2] See ESC Electricity and Gas Licences https://www.esc.vic.gov.au/electricity-and-gas/electricity-and-gas-licences-and-exemptions/electricity-and-gas-licences#toc--electricity-retail-licences-