



14 December 2023

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: 2024-25 Victorian Default Offer – Request for comments paper

Origin Energy (Origin) appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) request for comments paper (the Paper) for the 2024-25 Victorian Default Offer (VDO).

Origin generally supports the ESC's decision to maintain its existing method to calculate the VDO for 2024-25. We note the VDO objective requires prices to be set at a level that provides a reasonably priced electricity option that allows retailers to recover efficient costs. It is within this context we have framed our discussion of the various matters raised in the request for comments paper.

Wholesale Energy Cost

Origin agrees that using a combination of ASX Energy cap and swap trade data remains an appropriate approach to determining a retailer's hedging costs, and do not consider there is a need to augment the methodology to capture alternate instruments that may also be used to manage peak wholesale price risk.

Incorporating other instruments that may be used to manage peak price risk such as over the counter (OTC) contracts would generally increase the complexity of the price setting process and reduce transparency, as the terms and conditions of those contracts are not readily available in the public domain and can be more bespoke.

Retail Allowance

We support maintaining the current approach to deriving the retail margin using modelled outcomes from the Expected Returns Approach validated with market-based data. However, to increase the transparency and predictability of the approach, the ESC should clarify what market-based evidence it will use to verify modelled outcomes and how it will interpret and apply this data on a consistent and ongoing basis.

In the Final Determination for the 2023-24 VDO, the decision was made to lower the retail margin from 5.7 to 5.3 percent. However, the rationale for this remains unclear and in our view is not supported when looking at recent market outcomes. The previous margin of 5.7 per cent has facilitated new entry and robust price competition to the benefit of consumers. The last decade has seen growth in the Victorian retail sector with now 34 active retailers and small and medium sized retailers holding an approximate 23 percent market share.

With increased market participation there has been greater price-based competition. Since 2020, more than three quarters of market offers have been below the Victorian Default Offer. Additionally, there has

not been excess profits with EBITDA margins for Victorian retailers progressively declining and is now at historic lows.

We note that in reducing the margin, the ESC cited comparisons with other jurisdictions whose margin may have also been lower. However, this does not provide a basis for lowering the margin in Victoria given lower levels of systematic risk in these jurisdictions.

Origin therefore considers there is a strong case to retain the retail operating margin at 5.7 per cent.

Network Prices

We propose that the Draft Determination makes clear that in the absence of approved network prices the ESC will use prices submitted by the networks in their annual pricing proposals for 2024-25. These prices represent the best information available in that they should reflect the recently approved revenues and demand forecasts from the AER's revenue determination.

Additional commentary on these and other matters contained in the ESC's request for comments paper are provided at Attachment A.

If you wish to discuss any aspect of this submission further, please contact Sean Greenup (sean.greenup@originenergy.com.au) or Shaun Cole (shaun.cole@originenergy.com.au).

Yours Sincerely,



Steve Reid
General Manager, Regulatory Policy

1. Wholesale Energy Costs

- [1] As noted in the Issues Paper, the ESC excluded peak swaps from the estimation of the wholesale electricity cost (WEC) benchmark for the 2023-24 VDO on the basis those contracts were no longer traded in meaningful volumes. This in turn led to Frontier Economics' modelling including a larger number of ASX Energy base cap and base swap contracts in the WEC. We agree that using a combination of ASX Energy cap and swap trade data remains an appropriate approach to determining a retailer's hedging costs, and do not consider there is a need to augment the methodology to capture alternate instruments that may also be used to manage peak wholesale price risk.
- [2] It is broadly accepted that futures trading data generally provides for the most accurate representation of a typical retailers' efficient costs. This is reflected in the Australian Energy Market Commission's (AEMC) advice on best practice retail pricing methodologies, and Frontier Economics' recent assessment of the DMO methodology.¹
- [3] It is also clear that retailers continue to rely on ASX Energy contracts to manage their wholesale risk. The Australian Energy Regulator's (AER) 2023 State of the Energy Market noted that the liquidity ratio (contract trading relative to underlying demand) increased in Victoria during 2022-23, with traded volumes far exceeding underlying demand.² Further, even in circumstances where ASX Energy trading volumes are lower relative to previous periods, the transparent futures data is still a key point of reference for retailers and generators when pricing other products.
- [4] In the absence of meaningful trade volumes of peak swap contracts, determining an efficient retailer's hedge position based on a combination of ASX Energy base swap and cap contracts is appropriate, and adequately accounts for exposure to peak wholesale prices. It is also consistent with the general approach applied by ACIL Allen under the 2023-24 Default Market Offer (DMO) process.³
- [5] Incorporating other instruments that may be used to manage peak price risk such as over the counter (OTC) contracts would generally increase the complexity of the price setting process and reduce transparency, as the terms and conditions of those contracts are not readily available in the public domain and can be more bespoke. For example, weather derivatives (which can be used to manage price risk during high demand periods), are generally highly specialised and can include a range of terms and conditions (e.g. number of geographic reference points, event triggers, maximum duration, or number of events within a period, cost thresholds before paying out, payout limits etc.). It would also be challenging to accurately standardise the terms and conditions of such instruments to derive an associated hedge cost for a typical retailer.
- [6] The above factors would limit the extent to which industry and consumers could meaningfully interpret and engage with the analysis to test its validity, while also reducing the predictability / stability of the VDO. It should also not be assumed that incorporating these instruments into the hedging strategy would necessarily alter (or lower) the WEC estimate. For example, weather derivatives are relatively high cost products that also expose retailers to a higher degree of basis risk than cap contracts.⁴ In a scenario where the inclusion of other instruments resulted in a lower WEC estimate that is potentially not achievable by smaller retailers / new entrants, this could also be detrimental to retail market competition, as acknowledged by Frontier Economics.⁵

¹ AEMC, 'Advice on best practice retail price methodology – Final Report', 27 September 2013, pg. 39; Frontier Economics, 'Review of retail wholesale cost estimation methodology – Final Report for the AER', 14 April 2022, p. 33.

² AER, 'State of the energy market 2023', 5 October 2023, pp. 48-49.

³ ACIL Allen, 'Default Market Offer 2023-24 – Wholesale energy and environment cost estimates for DMO 5 Final Determination', 23 May 2023, pg. 74-75.

⁴ This is because spot prices do not always align with weather events.

⁵ Frontier Economics, 'Review of retail wholesale cost estimation methodology – Final Report for the AER', 14 April 2022, pg. 30.

Recommendation(s)

- Hedging costs should continue to be determined using ASX Energy cap and swap trade data and benchmarked with broker data, and other OTC contract data collected by the ESC.

2. Retail Operating Margin

- [7] In its 2023-24 Draft Decision, the ESC concluded that there was no clear evidence that the retail margin should be changed and proposed to keep the margin at 5.7 per cent.⁶ However, in its Final Decision, the retail margin was decreased to 5.3 per cent with the following reasons cited:
- Additional retailers have sought to enter the market.
 - Since 2020, most retailers have offered market offers below, and sometimes well below, the VDO.
 - On average, retailers' reported retail margins have decreased.
 - Retail margins set by other regulators have decreased.
 - 5.3 per cent is within the range of retail margins produced by the expected returns approach.
- [8] However, there was no defined criteria or explanation for why the above observed market outcomes justified a change in the margin. In addition, there was no link established between the market data that was observed and the Expected Returns Approach. As we discuss below, Origin's examination of the above parameters does not support the rationale for reducing the retail margin. This is given that the previous margin of 5.7 per cent has supported new entry and robust price competition to the benefit of consumers. Additionally, declining EBITDA margins reinforces that retailers are not making excessive profits, and any further reduction runs the risk of EBITDA falling to unsustainable levels.

Market entry

- [9] The last decade has seen growth in the Victorian retail sector with now 34 active retailers and small and medium sized retailers holding about a 23% market share. As the number of competitors in the market has increased, there has been a decrease in the market share of large retailers.⁷ This reduction in market concentration is reflected in the Herfindahl-Hirschman Index (HHI) progressively decreasing and is now approaching 0.1, notably lower than other NEM jurisdictions that hover around the 0.3 mark.⁸
- [10] A margin of 5.7 per cent has provided sufficient incentive for not only new entry, but for these entrants to aggressively compete and win market share from larger retailers.

Market discounts

- [11] With increased market entry there should be a clear expectation this will translate into price-based competition. Since 2020, more than three quarters of market offers have been below the Victorian

⁶ ESC, 'Victorian Default Offer 2023-24 Draft Decision', p. 43.

⁷ ESC, 'Victorian Default Offer 2023-24 Final Decision', pp. 52-52.

⁸ ACCC, 'Inquiry into the National Electricity market – November 2022 Report', 23 November 2022, p. 70.

Default Offer.⁹ We consider that it is positive that three quarters of the market have obtained better offers.

- [12] Over the period 1 July 2020 to 30 June 2022, the median market offer in Victoria was 11 per cent below the VDO. By way of comparison the median discount off the Default Market Offer in Ausgrid was 17 percent, Endeavour 16 per cent and Energex 14 per cent.¹⁰ Given the AER allowed for a 10 per cent retail allowance compared to 5.7 per cent in Victoria, this level of discounting reflects the differences in the respective retail allowances. There is no evidence to suggest there is excessive discounting in Victoria.
- [13] Notwithstanding, to obtain a better understanding of the appropriateness of the Victorian discounts, retailer profitability also needs to be examined.

Retailer profits

- [14] The most widely used metric to assess retailer profitability is EBITDA. Average retail EBITDA for Victorian retailers in 2020-21 was 4.8 per cent. In 2021-22, this dropped to 1.5 per cent.¹¹ This indicates that between 2020-21 and 2021-22, there was a 16.7 per cent reduction in retailer earnings per customer. The data also shows that retailer earnings have reduced by 40.4 per cent per customer since 2017-18.¹²
- [15] The actual retail EBITDA margins of 4.8 per cent and 1.5 per cent are significantly outside of the range of efficient EBITDA margins identified by Frontier in its 2019 analysis.¹³
- [16] Collectively this shows that there has been increased market entry, price-based competition and reducing retailer profitability. As noted in the Market discounts section above, discounting is not excessive when compared to other jurisdictions with higher retail allowances and retailer profitability is at its lowest level since the reintroduction of price regulation.

Comparison with other regulatory decisions

- [17] As part of its approach, the ESC cross-checks the expected returns outcomes against the range of retail margins set by Australian regulators in their latest regulatory decisions. However, this requires caution because these rates are not directly comparable. Furthermore, as the ESC notes continuing to use regulatory benchmarks from other regulators to set margins creates circularity.
- [18] In the case of the AER, their retail margin includes a retail allowance and an implied competition allowance. Neither rate is separately identified so that a direct comparison of the AER's 10 per cent margin with the ESC's rate is not meaningful.
- [19] With respect to the Australian Capital Territory (ACT), the Independent Competition and Regulatory Commission (ICRC) noted that in making its decision of 5.3 per cent, the efficient retail margin in the ACT may be lower than in other NEM jurisdictions, such as Victoria, given the lower level of customer related risks in the ACT.¹⁴ The ACCC's final report from the Retail Electricity Pricing Inquiry showed that customer related risks, such as bad debts, were found to be a significant source of variability in retail costs incurred by retailers. As noted by the ACCC, the ACT has relatively low levels of consumer debt, hardship and disconnection rates, and the highest median weekly household income across NEM jurisdictions. These factors suggest that the

⁹ ESC, 'Victorian Default Offer Final Decision', p. 49.

¹⁰ Origin analysis using AER Annual Retail Market Report 2022-23, Appendix 8, 30 November 2023.

¹¹ ESC, 'Victorian Default Offer Final Decision', p. 53.

¹² Origin analysis using Figure 9, ESC, 'Victorian Default Offer 2023-24 Final Decision', p. 53.

¹³ Frontier, 'Retail Costs and Margin, A Report for the Essential Services Commission', 24 April 2019, p. 29.

¹⁴ ICRC, 'Draft Report, Electricity Pricing Investigation 2020-24', February 2020, p. 43.

probable incidence of bad and doubtful debts in the ACT may be lower than that in any other NEM jurisdiction.

- [20] In the case of Tasmania, the Office of the Tasmania Economic Regulator (OTTER) considered that compared to standalone retailers in other Australian jurisdictions, Aurora Energy may face lower than average risks relating to the wholesale electricity price, setting aside volume-related risks.¹⁵
- [21] Given this lower risk profile both the ICRC and OTTER considered that their retail margins are not directly comparable to other NEM jurisdictions and that their rates should be lower.
- [22] With respect to Queensland, the Queensland Competition Authority (QCA) no longer determines an overall retail allowance. The ESC has compared the AER's retail operating costs against the QCA's tariffs at the AER's assumed usage rate and inferred a margin based on the difference in costs. However, this is not a direct comparison because it does not consider the QCA's Standing Offer Adjustment.¹⁶ Taking this into account, we believe the QCA margin would be much higher than the rate inferred by the ESC.

Expected Returns Approach

- [23] We consider that the Expected Returns Approach provides reasonable theoretical evidence to infer margins which are likely to prevail in a competitive market. However, because it is a theoretical model, underpinning assumptions need to be made.
- [24] The Expected Returns Approach places a high reliance on the economic theory of the Capital Asset Pricing Model and an estimated relationship between the profitability of electricity retailers and economic conditions. The approach holds cost of capital assumptions constant under varying market conditions. This means that during periods of good economic conditions when consumption increases, there is a reduction in discount rates, and there is a corresponding increase in discount rates during weak economic conditions.
- [25] Since Frontier undertook its analysis in 2019, we have witnessed significant market and broader economic volatility. There has been a global pandemic, the war in Ukraine impacting fuel prices, and now significant cost of living pressures. In response there has been significant Government economic stimulus in response to COVID and now through the Energy Bill Relief rebates.
- [26] This has resulted in significant market volatility, GDP volatility, and lower consumption volumes. The expected returns approach is highly sensitive to each of these parameters.
- [27] As shown in Chart 1, consumption volumes have been on a downward trajectory in Victoria since 2009-10 and have now reached their lowest levels. Chart 2 shows the annual growth in GDP. Since 2004-05 GDP growth has oscillated within a 2 to 4 per cent bandwidth. Since 2018-19, it was negative followed by a spike to 4 per cent – volatility not seen since regulators have been calculating the Expected Returns Approach.

¹⁵ OTTER, '2022 Standing Offer Electricity Pricing Investigation Final Report', April 2022, p. 41.

¹⁶ The Standing Offer Adjustment is a 3.7 per cent premium on the QCA notified price to reflect the more favourable terms and conditions of standard contracts over market contracts. See QCA, 'Regulated retail electricity prices in regional Queensland 2023-24, Final determination', June 2023, p. 35.

Chart 1: Annual energy consumption in Victoria based on generated electricity¹⁷

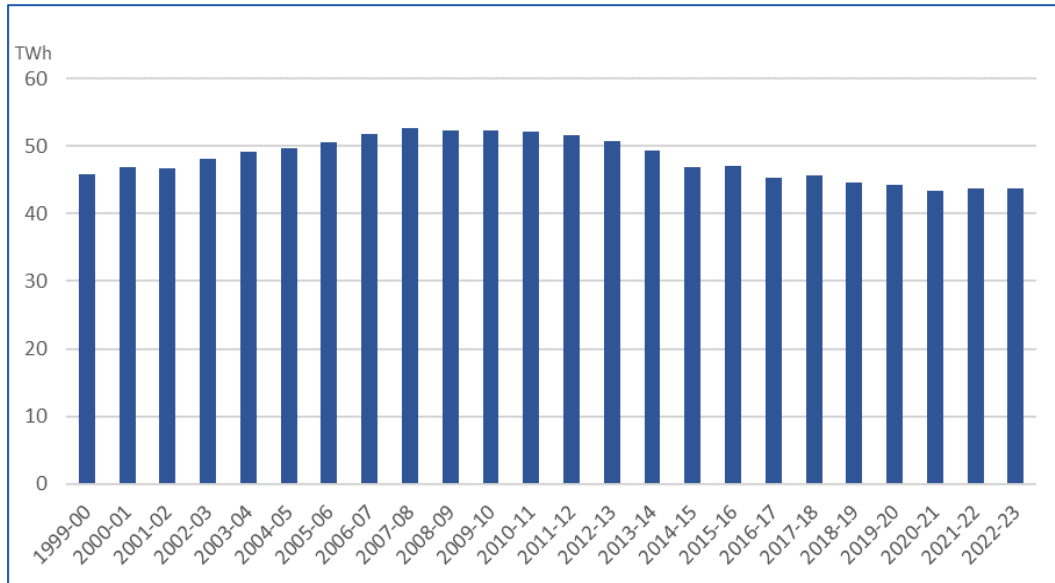
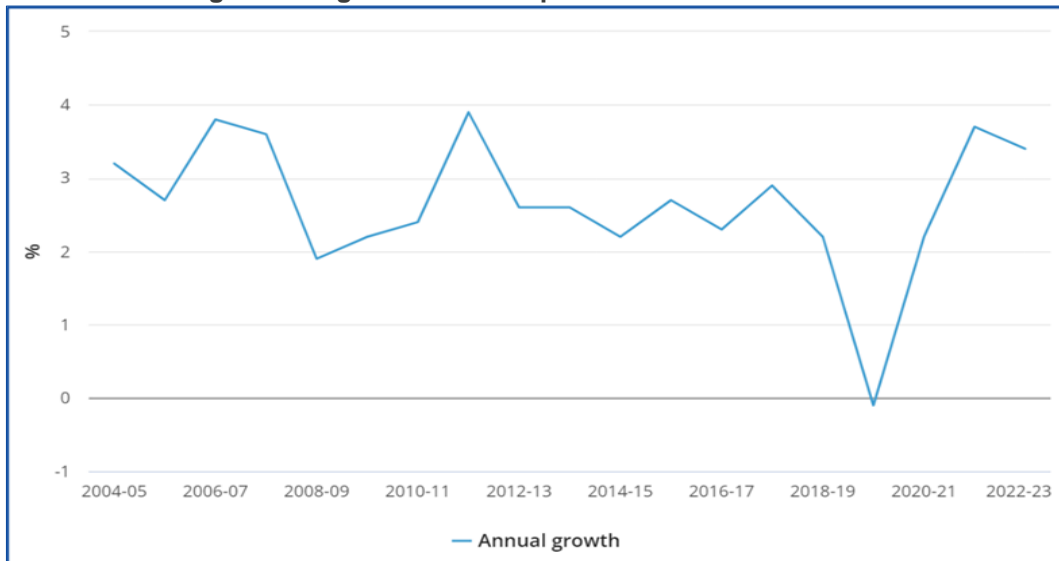


Chart 2: Annual growth in gross domestic product¹⁸



[28] The key objective of the Expected Returns Approach is to estimate the minimum retail margin required to compensate equity investors in a notional electricity retailer for an assumed level of systematic risk. That is, the retail allowance is to provide reasonable compensation for the potential variation in response to various economic conditions.¹⁹

¹⁷ Origin analysis using [Annual electricity consumption - NEM | Australian Energy Regulator \(AER\)](#), AER Reference 11048184, accessed 30 November 2023.

¹⁸ Australian National Accounts: National Income, Expenditure and Product, accessed 30 November 2023.

¹⁹ SFG Consulting, 'Estimation of the regulated profit margin for electricity retailers in New South Wales (Methodology and assumptions)', 14 August 2009, p. 7.

- [29] What the above charts show is that since the last time the ESC undertook an Expected Returns Approach analysis, there has been falling volumes and unprecedented economic and market disruption. All things being equal we would expect this would result in an increase in systematic risk that would typically warrant an increase in the retail margin.
- [30] Choosing the ‘appropriate’ margin from within that range of modelled outcomes from the Expected Returns Approach is not a straight-forward exercise and regulators have rightfully corroborated outcomes with market-based or complementary evidence to inform that choice.
- [31] As highlighted in the preceding discussion, indicators such as the level of discounting or revealed retailer returns can be difficult to interpret and do not necessarily provide conclusive evidence as to whether the existing margin should be at the lower or higher end of the expected returns range. Similarly, retail margins produced by other regulators may not be directly comparable to the VDO margin, including given the basis of construction and differing risk profiles. For these reasons, choosing a margin within the expected returns range tends to be more subjective than objective.
- [32] To increase the transparency and predictability of the process, the ESC should clarify what market-based evidence it will use to verify modelled outcomes and how it will interpret this data on a consistent and ongoing basis. This would involve, for example, an assessment of retailer EBITDAs to determine the implications both on retailers and customers of targeting a lower retail allowance. In the absence of such analysis, the choice of retail margin risks unintended consequences including impacting retail competition, switching activity or retailer viability, all of which have long-term customer impacts.

Recommendation(s)

- We support maintaining the Expected Returns Approach validated with market-based data.
- We consider that the ESC should define the triggers or time intervals for updating the Expected Returns Approach.
- The ESC should define what market-based evidence it will use to verify Expected Returns Approach modelled outcomes and how it will interpret and apply this data on a consistent and ongoing basis.

3. Retail Costs

- [33] We have previously supported the ESC’s approach to escalate the current retail operating costs by inflation. Notwithstanding, we recognise the ESC preference to improve the accuracy of the retailer costs calculation by accessing and utilising the appropriate data sets.
- [34] In the case of retail operating costs and bad and doubtful debt, retailers already provide the relevant data to the ACCC as part of their ongoing market monitoring. We support the ESC using this data acquired through its own data collection processes that is consistent with the costs reported to the ACCC by retailers.

4. Network Costs

- [35] We support the ESC using AER approved network prices for 2024/25. In the event this is not possible because of timing issues associated with the AER’s approval of network prices, the ESC ought to use the 2024-25 network tariffs submitted by the Victorian networks for approval to the

AER and to apply a “true-up” in account for any differences between proposed and approved network tariffs in future years.

5. Environmental Costs

[36] We support the ESC continuing to use its current method to determine Small Scale Renewable Scheme costs, Large Scale Renewable Scheme costs, and Victorian Energy Upgrade costs.