7 September 2023

Mr Joe Dimasi
Senior Commissioner
Independent Competition and Regulatory Commission
PO Box 161
Civic Square ACT 2608

Submitted by email: icrc@act.gov.au

Dear Mr Dimasi,

Standing Offer Price from 1 July 2023 – Issues Paper

Origin Energy Limited (Origin) welcomes the opportunity to provide comments on the Independent Competition and Regulatory Commission's Standing offer prices for the supply of electricity to small customers from 1 July 2024 Issues Paper.

We believe a regulated retail price should be set at an amount that allows a regulated retailer to recover efficient costs, while also facilitating competition, and ensuring that customers are protected from unreasonably high prices especially in an environment of cost of living pressures. We acknowledge that the ICRC faces a challenging task in balancing these objectives amid the recent significant increase in wholesale market volatility.

Origin generally supports the ICRC's decision to maintain its existing method to calculate regulated prices for the next three years. However, the ICRC ought to ensure that with recent increased wholesale price volatility that actual efficient wholesale costs fall within its range of modelled outcomes. Otherwise, we are concerned that this could result in a benchmark price that exceeds a retailer's efficient costs. We believe it is incumbent on the ICRC to ensure that its method produces outcomes that are achievable.

In terms of cost of living pressures, the impact of higher energy prices, particularly for vulnerable customers, is of utmost importance, but this should be done outside of the regulated price setting through concession schemes, hardship programs and direct bill subsidies.

Origin's comments on specific matters raised in the ICRC's Issues Paper are contained in Attachment A.

If you wish to discuss any aspect of this submission further, please contact me on either (07) 3867 0620 or sean.greenup@originenergy.com.au.

Yours sincerely

Sean Greenup
Group Manager Regulatory Policy

Should we reinstate a materiality threshold for pass-through applications? If so, what threshold level is appropriate?

We support the current approach of assessing cost pass-throughs as part of the annual price recalibration process. A pass-through for an annual regulatory period is not practicable because by the time ActewAGL has sufficient cost information to make an application and the ICRC conducts an assessment and consultation, the timing would more than likely overlap with its annual recalibration.

We consider a materiality threshold to capture extraordinary costs that ActewAGL is unable to absorb for a year would be sufficiently high that it would require a broader regulatory or policy intervention.

For these reasons we do not consider there is a need to reinstate the materiality threshold.

Do you have any comments on our assumption that prudent retailers will hedge their exposure to risk by purchasing hedging contracts on the ASX?

We consider ASX futures trades continue to provide a good market-wide representation of how retailers manage both their energy and capacity positions and the associated costs. We believe it is far more common for retailers to use financial derivatives to hedge risk than own generation or enter PPAs, meaning approaches based on these financial derivatives are more likely to reflect a typical retailer's efficient costs under current market conditions. Information on ASX trades is also publicly available and verifiable, which are important attributes in the context of supporting a regulated pricing review.

Incorporating a broader suite of products would generally increase the complexity of the price setting process and reduce transparency, noting the terms and conditions of more bespoke products are not readily available in the public domain. This 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 regulated prices.

Do you have any comments on the approach to determining an appropriate contract position, and specifically on the treatment of peak swap contracts?

The purpose of a regulated price is to estimate wholesale costs to reflect the portfolio of a prudent and risk averse retailer.

The use of peak swaps is a necessary tool to obtain an efficient level of hedge cover. We strongly opposed the decisions of both the AER and the ESC to remove peak swap contracts from their respective hedging strategies.

We believe the removal of peak swaps by both the AER and the ESC has increased the risk profile of the hedging strategy with retailers more exposed to high demand/price periods relative to previous decisions. This approach to hedging is fundamentally inconsistent with the risk management practices of a prudent retailer.

The principles guiding the development of the hedging strategy should be expanded to account for the potential resilience to different market outcomes, with the objective being to determine a strategy that also minimises potential earnings at risk (EaR). This is appropriate given that remaining solvent and minimising possible losses is the foundation of a retailer's risk management framework and a primary consideration in determining a viable hedging strategy.

Do you have any comments on the length of the averaging period or the proposed dates for the averaging period?

Origin generally supports the existing book build process which occurs over a 23-month period and agrees pricing stability is important for customers. We believe there could be merit in the ICRC considering assigning a higher weighting to contract trades and prices that occur closer to the relevant period, which would better account for more up to date pricing expectations. However, adopting a higher percentile WEC estimate would obviate the need for such a change as it would reduce the potential forecasting error.

Do you consider that the current approach of using actual load data for 5 calendar years remains appropriate?

We support the continued use of a five-year period.

The current net system load profile (NSLP) excludes the peakier and more variable load of solar PV customers, the penetration of which continues to grow. This creates an inherent bias toward underestimating hedging costs and by extension the WEC, given the lower (relative) cost of hedging flatter load profiles.

Origin notes that in its recent determination for retail electricity prices in regional Queensland, the Queensland Competition Authority and its modellers (ACIL Allen) incorporated smart meter data in combination with the NSLPs and controlled load profiles to estimate the WEC.[1] ACIL noted that the use of interval meter data in addition to the NSLP improves the estimation of the cost of supplying energy to small customers by better reflecting the shape of small customers' load.[2]

We recognise that the use of smart meter data creates issues of transparency and validity given AEMO does not make interval meter load profile data publicly available, which means that it cannot be readily accessed by stakeholders for verification. Notwithstanding, as noted by ACIL in its advice to the AER in its recent DMO review, it is better to commence using the interval meter data in combination with the NSLP data sooner rather than later as it removes the risk of a step change in prices if the interval meter data is included all at once, when penetration is higher. This risk is particularly relevant if the aggregate load profile of customers on interval meters is different to that of customers on the NSLP.[3]

We encourage the ICRC to examine interval meter data as part of this decision to determine what the implication of a change in the NSLP would have on prices and what transition methods would, if any, need to be applied.

Do you have any comments on the approach to calculating spot prices?

It is much easier to estimate the WEC during periods of contract price stability, and the error in the WEC estimate (due to contract price variation) is likely to be greater in an environment of increasing prices – this is because of the skewed nature of wholesale electricity prices in the NEM (prices can increase a lot more than they can decrease) and demonstrates the risk faced by retailers.

Spot price modelling is inherently challenging and contingent on iteratively running many statistical simulations with varying parameters, including forced outage profiles, weather sensitive peak demand shapes / renewable output and expected fuel costs. There is heightened potential for greater variation

[1] Queensland Competition Authority, Final determination, Regulated electricity prices in regional Queensland 2023-24, June 2023, pp. 26-27.
[2] ACIL Allen, Estimated energy costs, For use by the Queensland Competition Authority in its Draft Determination of 2023-24 retail electricity tariffs, 15 February 2023, p. 11.
[3] ACIL Allen, Wholesale energy and environment cost estimates for DMO 5 Draft Determination, p. 17.

in some of these parameters, due to exogenous shocks (e.g. global fuel supply pressures, pandemics, floods) that can lead to materially different market outlooks. This was evidenced by events over the last 18 months, where a combination of international and domestic factors (including high coal outage rates, low variable renewable energy (VRE) output and weather driven demand) contributed to higher, and more volatile spot price outcomes than would have typically been anticipated at that time of year (i.e. the relatively benign autumn period and over winter).

The potential for more volatile market outcomes is consistent with the Reliability Panel's finding that greater reliance on weather dependent VRE is changing the risk profile of the NEM. According to the Panel, the distribution of unserved energy (USE) in a high VRE power system is likely to shift towards longer duration, higher impact reliability events, particularly due to the risks from low VRE generation due to co-incident low solar and wind generation events.[4]

While some events may be considered unlikely compared to the median / expected market outcome, it is clear they present a material risk for retailers and are within the bounds of scenarios that would be considered under any hedging strategy. This is because even limited exposure to higher pricing events can be detrimental to retailers, as evidenced by the six retailer failures on the national market that occurred in 2022. A prudent retailer will typically run stress tests to evaluate exposure to extreme prices for prolonged periods and seek to hedge that exposure in line with established risk limits.

An outworking of the above is there is a higher likelihood in the current environment that modelled WEC estimates may not reflect the actual costs incurred by a prudent retailer during the regulatory period. The material uplift in wholesale electricity prices observed over winter 2022 to levels not anticipated in the WEC modelling provides a relevant case study in this respect.

For these reasons adopting a higher margin for forecast error is a conservative approach to recognising the varying degree of spot price uncertainty.

Are changes required to the estimation of the volatility allowance? If so, how should we determine the volatility allowance?

The volatility allowance 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 estimate.

The challenge with this approach is that 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. The volatility allowance takes no account of the likely corresponding variance in price.

Origin considers that a better alternative would be to adopt a higher margin for forecast error as this would circumvent the need for a volatility allowance.

Do you have any comments on our proposed changes to the timing of LRET and SRES cost estimates?

We support the ICRC continuing to use its market-based approach to determine environmental costs. We support bringing forward the cut off date to ensure that the ICRC can release its final decision in a timely manner. In doing any differences in costs between forecast and actual should be reflected in the annual price recalibration process.

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[4] AEMC Reliability Panel, '2022 Review of the Reliability Standard and Settings', pg. 39.

What benchmarks should the commission consider in determining the retail operating cost allowance?

We note that the AER and ESC have recently moved away from using the IPART cost benchmark. In the case of the AER, it has commenced using ACCC cost data. We believe this would also be a pragmatic choice of data to use for the ICRC. It is transparent and consistent, and it is updated regularly. We also note that the ACCC data combines NSW and ACT data.

We believe aggregated NSW and ACT data is appropriate on the basis it is representative of retail businesses operating at scale; similar to ActewAGL. Therefore, it provides an appropriate point of comparison of how retail costs are moving from year to year in a more competitive environment than the ACT where ActewAGL holds the vast majority of market share.

Do you have any comments on the approach we should adopt for determining the retail margin?

The setting of the retail allowance is a crucial part of achieving and ultimately balancing the various components of a regulated price. The allowance should be set such that it allows retailers to recover a reasonable margin (commensurate with the level of risk) and incentivises innovation / competition in the market and consumer engagement, while also ensuring customers are protected from unreasonably high prices. This is a delicate balance, made even more challenging in an environment of rising costs that increases both consumer prices and the risks borne by retailers.

Considering rising inflation and interest rates and the impact these have in the derivation of a weighted average cost of capital and therefore margins, we consider a conservative approach would be to retain the current allowance.