18 October 2019

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

Email: icrc@act.gov.au

Dear Mr Dimasi,

RE: STANDING OFFER PRICES FOR SMALL ELECTRICITY CUSTOMERS FROM 1 JULY 2020 – ISSUES PAPER

Origin Energy appreciates the opportunity to respond to the Independent Competition and Regulatory Commission's (Commission) Issues Paper on Standing offer prices for the supply of electricity to small customers in the Australia Capital Territory (ACT) from 1 July 2020.

In May 2019, the ACT Treasurer issued a terms of reference requiring the Commission to make a price direction for the standing offer prices for the supply of electricity to small customers. The terms of reference are similar to that received by the Commission for the 2017–20 electricity price investigation. The key difference is that the new terms of reference includes an additional clause (clause 4(4)) which requires the Commission to consider whether changes are needed in the Territory to improve the transparency and comparability of electricity offers.

The Commission indicates that it intends to implement the updated pricing methodology from its 2018–19 electricity model and methodology review. Origin considers it incumbent on the Commission to ensure that standing offer prices are set such that they encourage rather than inhibit the development of retail competition in the ACT. That is, prices should be set at a level that will allow efficient retailers to compete below the regulated price while still earning a normal return on capital.

The benefits of retail competition in the electricity market are well established. Retailers not only offer competitive price discounts and innovative price options, but customers benefit from improved customer service and experience with added services such as metering solutions, distributed energy options (e.g. solar, batteries) and product offerings to assist with bill management. These benefits are noted by the Australian Energy Markets Commission (AEMC) in their recent Retail Competition Review.[1] In addition, we note that the Australian Competition and Consumer Commission (ACCC) recently indicated that it:

> *considers that effective competition between retailers is the best vehicle for tackling inefficiencies in the supply of electricity to drive prices down further*[2]

[1] AEMC, Retail Competition Review 2019 – Final Report, e.g. p. xii-xiv.
[2] ACCC, Submission to the Victorian Default Offer to apply from 1 July 2019 – draft advice, April 2019.

While there have been encouraging signs in the ACT electricity market, the AEMC recently found that effective retail competition is yet to fully emerge.[3] In our view, this is due to the risk that electricity tariffs will not reflect a retailer's actual cost of supply. If retailers are confident that regulated retail prices will reflect a retailer's cost to supply, retailers will enter the market and appropriately educate and engage customers on the best product option for them. Consistent with this view, we note that the AEMC indicates that the most cited barrier to entry for retailers is retail price regulation.[4]

One of the Commission's key objectives under the ICRC Act is "to promote effective competition in the interests of consumers"[5] and

> *…to promote the efficient investment in, and efficient operation and use of regulated services for the long-term interests of consumers in relation to the price, quality, safety, reliability and security of the service.*[6]

Accordingly, Origin considers it vital that the Commission strike the right balance when determining its standing offer to ensure that retail competition in the ACT reaches its full potential. This involves allowing retailers to recover their efficient costs to facilitate entry and operation in the ACT market. For this reason, Origin considers that 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.

Origin has provided further comments on the proposed regulated pricing framework and approach for electricity customers below.

1. Price control approach

1. How much discretion should ActewAGL have when applying the maximum percentage increase, as determined by the Commission, to its suite of regulated tariffs? How would this contribute to improving the transparency and comparability of electricity offers?

Origin supports the adoption of a weighted average price cap (WAPC) ahead of setting actual tariffs or capping revenues. A WAPC approach encourages more efficient formulation of cost-reflective prices. It also more closely approximates a fully competitive outcome and so is preferable since an underlying objective of all energy price regulation should be to move the market towards effective competition.

2. Pricing model

2. The Commission is seeking feedback on its approach to estimating the heuristic (i.e. rules) for determining an appropriate contract position.

The Commission proposes the use of a heuristic linked to electricity demand to determine the contract position. Origin considers that a heuristic is simple, transparent, and does not require forecasts of future prices and is therefore preferable to a modelling approach. However, given the variety of potential contract positions, Origin considers the Commission should adopt a conservative hedging strategy to accommodate a wide range of possible contract positions.

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[3] AEMC, Retail Competition Review 2019 – Final Report, p.47.
[4] Ibid, p. 27.
[5] Section 7(a) of the *ICRC Act 1997*.
[6] Ibid, Section 19L.

3. Do you have any comments on the proposed dates for the averaging period?
4. What is an appropriate period for averaging forward prices for the purpose of scaling spot prices?

In terms of the development of energy purchase costs, Origin considers the key calculation assumptions is a forecast load profile and the forward-looking cost of energy.

The Commission indicates that it intends to use the most recent five calendar years of load and spot price data from the Australian Energy Market Operator (AEMO), updated annually as part of the annual price recalibrations. The half-hourly spot prices for each quarter will be scaled up to the average base swap forward price for the quarter less the forward price margin and the contract premium is to be set at five per cent. The Commission notes that it will need to determine an appropriate period for calculating an average forward price for the purpose of scaling spot prices.

Origin considers it important that load simulations adequately represent the variability in customer load (particularly peak demands) that retailers experience. The underlying demand data used to project load scenarios should be drawn from an extensive history that includes weather extremes. We would expect that complete sets of half hourly data are requested from AEMO and network businesses to support its analysis; a small sample is not adequate. We note that even if only five years of load data is available, greater weather variability can be simulated using the relationship between weather variables (for which there is a longer history of reliable data) and load; this is the approach the Queensland Competition Authority (QCA) applies. A tight range of demand distributions naturally leads to a more efficient 'model hedge position' in turn understating modelled energy costs.

The Commission indicates that it intends to continue using a forward price margin of five per cent, consistent with that used by the Essential Services Commission (ESC) in Victoria. We note that the ESC adopts a 12 month trade-weighted average of forward contract prices for the purpose of scaling spot prices. The ESC indicates that a 12 month trade-weighted average provides a reasonable benchmark amongst the range of approaches that could be taken by retailers, and also provides greater stability in prices than a 40 day average.[7]

In adopting a market-based approach, we believe it is vitally important that the model hedge book assumed is realistic, that futures prices are averaged over an appropriate period, that load shapes exhibit realistic diversity, and that pool prices have a reasonable distribution and correlation to load. The hedge book should not be determined ex-post to optimise the load outcomes. Origin has previously observed perverse regulatory modelling outcomes where a long cap position coupled with high cap payouts delivers a lower energy price allowance, i.e. insurance was modelled as a benefit rather than is usually the case a cost.

We believe determining the hedge strategy of the representative firm is to a large extent a theoretical exercise. However, the Commission can inform its analysis by observing market outcomes in the retail sector. We accept that choosing a short averaging period is available to retail businesses. However, we believe that most retail business hold a diverse portfolio of hedge contracts entered into over an extended period of time. This means that a retailer will only need to hedge a proportion of its load at any point in time. Holding a portfolio of hedge contracts allows the retailer to manage its wholesale exposure. We note the Australian Energy Regulator (AER) has adopted a similar approach when considering debt costs, moving from an on-the-day method to a 10-year rolling average over an extended period.

Therefore, Origin supports the use of futures prices in estimating electricity wholesale costs that are averaged over a period that reflects the time over which a retailer acquires hedges in practice (one to two years).

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[7] ESC, Victorian Default Offer to apply from 1 July 2019, May 2019, p. 33.

5. What benchmarks should the Commission consider in determining the volatility allowance?

The Commission has decided to include 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 will be determined using a benchmarking approach and will consider other regulatory investigations. For example, the Commission notes the recent ESC decision on the VDO included a volatility allowance that ranged from $0.12 MWh to $0.18 MWh across the five distribution zones in Victoria. The analysis suggests that a 15c/MWh premium accounts for all remaining wholesale volatility risk.

In relation to the recent ESC decision, we consider that the volatility allowance understates the level of risk costs associated with the expected exposure. Specifically, we consider it 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.

<u>LRET and SRES costs</u>

The Commission's pricing model determines LGC and STC prices based on publicly available spot price data averaged over an 11-month period. The Commission adds a holding cost to the certificates to account for the financing costs. The Commission assumes that these certificates are purchased evenly throughout a year. As such, the Commission intends to use the cost of debt for half a year as the holding costs for the certificates.

Origin supports the proposed use of the contract market to estimate LGC prices in this determination. However, we consider that the Commission ought to recognise that retailers acquire LGC's over a reasonable period and secure much of their LGC requirement through long term PPAs.

Specifically, the forward price curve for LGCs is in decline reflecting the anticipated delivery of enough large-scale renewable generation to meet the peak Renewable Energy Target in 2020 and no planned extension of the scheme. The Commission should carefully consider whether its approach of using the market price will adequately compensate retailers for their prudent LGC costs over the remaining years of the scheme. Retailers have progressively invested in renewables or entered into PPAs over the duration of the scheme with prices for earlier renewable projects generally made at a significantly higher price point, which may now be in excess of the current LGC/energy market price. There appears to be a risk of a perverse regulatory outcome over the remaining years of the scheme if the current LGC market price is applied without adjustment. Retailers will effectively be penalised for acting commercially and prudently by supporting sufficient renewable investment to meet scheme obligations.

However, the decline in LGC prices is a consequence of policy/regulatory mechanisms rather than market conditions. The RET will peak in 2020 with no replacement carbon scheme in place to provide value for renewables. The marginal value of an LGC has fallen because retailers collectively supported enough renewable build to meet their legislated RET obligations. Had this not been the case then renewable supply would be reduced and the LGC market price would naturally be higher.

With respect to SRES, small scale solar installations continue to experience a rapid growth in the rate of installation. This growth has outstripped the CER's estimates of the volume of small-scale certificates (STC) created.

We note that the most recent update from the Clean Energy Regulator (CER) in December 2018, indicates a significant surplus of STCs created in calendar 2018 estimated at around 6-8 million STCs. This represents a variance of over 20 per cent above the published small-scale energy percentage (STP). We suggest the Commission consults with the CER to better estimate a revised STP for inclusion in the Commissions analysis. Further, as the calendar 2020 STP is also relevant to this determination, we suggest that the Commission also consider the CER's current non-binding STP.

In addition to the above, Origin considers that the Commission will also need to make an allowance for other wholesale costs; these include:

- prudential capital costs – the costs a retailer incurs to provide financial guarantees to AEMO and lodge margins with the ASX or other hedge providers;
- Reliability and Emergency Reserve Trader (RERT) costs – AEMO is expected to incur RERT costs again next year. These are significant for Victoria; and
- AEMO directions costs - additional costs incurred as a result of directing generation outside the usual settlement process; an ongoing cost until Electranet commissions synchronous condensers.

6. Is the regulatory cost of debt for the ACT's water business an appropriate indicator of the cost of debt for an efficient electricity retailer in the ACT? What other cost of debt measures could the Commission use?

Origin considers that the Commission's cost of debt calculation for the ACT's water business do not provide an appropriate proxy for an efficient retailer in the ACT. The ACT water business is a low risk, regulated monopoly businesses, that can apply to pass through the cost of unforeseen regulatory events. Conversely, retailers operate in a competitive market with a multitude of risks including uncertain demand, wholesale market price volatility, ongoing regulatory risk and competitive pressures. Reflecting these increased risks, funding costs for retailers are significantly higher than those of a regulated water business.

Funding costs for Origin reflect a mixture of debt and equity. Accordingly, we consider that a commercial WACC provides a more accurate indication of holding costs than simply the cost of debt and should therefore be utilised by the Commission.

3. Retail costs

7. What benchmarks should the Commission consider in determining the retail operating cost allowance?
8. What are appropriate benchmarks for determining the retail margin for an efficient electricity retailer? Is there other information that the Commission should use to inform its decision on the retail margin?

<u>Retail operating costs (cost to serve)</u>

Origin considers retail operating costs need to reflect the actual costs retailers incur in supplying customers in the ACT in order to encourage business efficiencies, innovation and thus competition in the ACT electricity market. The risk for the Commission is that it sets its retail operating costs, and therefore its standing offer prices, at level that does not allow a number of retailers to recover their full efficient costs.

The Commission intends to continue using a hybrid bottom-up and benchmarking approach to estimate retail operating costs. The inputs to determine the retail operating cost allowance will be informed by the findings from current regulatory investigations and analysis, including the work by, amongst others, the ACCC and ESC.

In principle, Origin supports the use of a hybrid approach but notes that the determination of appropriate retail costs has produced a wide range of estimates across jurisdictions. For example, we note the recent ACCC Inquiry into the National Electricity Market report found that the cost to serve across the jurisdictions with competition ranged from $68 per customer in South Australia to $83 per customer in Victoria (real $2017/18)[8]. Further, the ESC in its recent VDO decision adopted a cost to serve of $134 per customer. The comparable retail operating cost currently set by the Commission is around $115 per

[8] ACCC, Inquiry into the National Electricity Market, August 2019, p. 105.

customer. The divergence in cost estimates highlights the difficulty in determining a comparable estimate of retail operating costs especially given the wide range of costs incurred by different retailers. Whilst it is difficult to make a direct comparison, we note that the recent 2019 Origin annual report indicates a cost to maintain of $126 per customer.

Origin externally publishes retail operating costs as part of our annual and half yearly financial reporting, detailing operating expenditure on cost to maintain (broadly equivalent to cost to serve) and cost to acquire (broadly equivalent to customer acquisition and retention costs) per average customer. Compared to public reporting of other retailers operating in similar competitive markets, we believe our retail operating costs per customer are at the lower end of costs in the market. A significant explanatory factor being our economies of scale from the largest number of electricity and natural gas customers nationally.

Given the variances in benchmarking results, it is essential that the Commission obtains a clear understanding of how cost estimates are derived and why these tend to depart so significantly from the publicly reported costs of retailers. Origin notes the importance of ensuring that retail operating cost components are consistent across the benchmark sample and are directly comparable to the full range of costs that the Commission is seeking to include in its retail operating costs. This increases the importance of ensuring that the approach to determining the inputs to the retail operating costs in the next price investigation is fully transparent and consistent with the cost recovery requirements of the Act. We urge the Commission to consult on the development of an appropriate data template to ensure that it collects data that is consistent across all retailers. In particular, it is important that the Commission consider the broad nature of retail costs and seek to understand the full suite of these costs before excluding any category in its assessment.

We believe the Commission should use publicly reported operating costs (audited annual accounts) to assess operating costs to which an adjustment should be made for foreseeable regulatory changes. Further, the Commission should include an allowance for retail depreciation and amortisation expenses, e.g. IT expenses are often capitalised and can form a substantial cost component. Allowance should also be made for funding working capital and meeting the prudential requirements (to the extent these are not provided for in the determination of energy costs) of operating in wholesale and associated financial markets.

In addition, we also seek greater clarification regarding the benchmarking method and how the results will be interpreted and applied. Specifically, it has been widely recognised that the difference between the cost to serve of retailers is very significant. Therefore, it is important that costs are defined correctly and that benchmarks are applied that strike a balance between achieving immediate efficient outcomes and creating incentives for ongoing efficiency gains.

We also believe that the Commission ought to consider an incentive-based approach similar to that applied to regulated networks where the regulated business is incentivised to improve efficiency over time and to share in those improvements with customers.

Customer Acquisition and Retention Costs (CARC)

Origin considers that an allowance for customer acquisition and retention (CARC) should be added to retail costs at a sufficient level to allow a hypothetical efficient retailer to recover the costs associated with engaging in competition. It should be noted that CARC is determined to not only allow for acquisition costs but also retention costs for a retailer defending its customer based in a competitive market. In all jurisdictions where Origin is an incumbent electricity retailer, it must use campaigns and discounts in order to win new customers and maintain an existing customer base. Origin anticipates that the same applies to ActewAGL in the ACT with these costs rising in recent years as competition is slowly increasing.

We note that the Commission does not currently include an allowance for CARC in its assessment of retail costs and its final report on the recent model and methodology review indicates that an allowance for CARC in the ACT is not warranted.

The apparent decision to exclude a CARC allowance from retail costs appears inconsistent with the Commission's decision to apply a benchmarking approach to the development of retail cost estimates. Specifically, Origin notes that the approach of including CARC in retail operating costs has been accepted in all recent past and current regulated pricing determinations in other jurisdictions across Australia. For example, the ESC provides a CARC allowance of $38 per customer in its current VDO, while the ACCC identifies a CARC range between $56 per customer in NSW to $80 per customer in South East Queensland (real $2017-18) in its recent Inquiry into the National Electricity Market. Whilst not directly comparable, we note that the recent 2019 Origin annual report indicates a cost to acquire/retain of $43 per customer.

Origin seeks clarification from the Commission regarding the application of a benchmarking approach where a critical component of the retail cost stack (CARC) is apparently omitted from the benchmarking exercise.

Retail margin

A retail margin is intended to ensure that a retailer is compensated for efficient costs and that a retailer earns a normal commercial margin for providing a product or service. A retail margin needs to cover a retailer for its risk weighted investment. A low margin is a significant impediment to the further development of competition and to the future investment in the energy sector in the ACT.

Origin supports the use of a benchmarking approach to determine the retail margin but notes that the current allowance provided by the Commission of 5.3 per cent is lower than current regulatory practice in other jurisdictions. For example, the ESC applies a margin of 5.7 per cent in its VDO and the recent ACCC report identifies a retail margin (EBITDA) of 6 per cent. Given the increase in market risk (e.g. wholesale volatility) and regulatory risk, we consider that the Commission should adopt a margin at the higher end of the range of available estimates. Setting the margin too low risks impacting retail competition in the market. Conversely, adopting a higher margin represents a conservative approach – facilitating retailer entry and competition in the ACT market with any upside in the margin effectively competed away as a result.

Origin note that the current combined retail operating cost and retail margin applied by the Commission in its standing offer prices in the ACT accounts for around 11 per cent of the residential customer bill. This compares with 17 per cent reported by the ACCC (including an allowance for CARC). Origin considers that the retail allowance (including the margin) is insufficient to allow a retailer to effectively perform in the ACT market and represents a significant impediment to the development of effective competition and the concomitant consumer benefits.

Transparency and Comparability

13. Are there any other issues the Commission should consider?

The Commission intends to assess the transparency and comparability of electricity offers in the ACT by examining how offers and discounts are marketed in the ACT. The Commission will focus on examining those aspects that have been identified as causing confusion amongst consumers in other jurisdictions including examining:

- whether retailers use a consistent reference price when advertising offers and discounts;
- whether discounts are applied in a consistent way across retailers; that is, whether discounts apply to the total bill or only to electricity usage; and
- the extent to which headline prices and discounts are conditional.

The Commission will also identify whether potential changes could be implemented, either by electricity retailers or by the ACT Government, to improve the transparency and comparability of offers.

Origin supports the provision of information and engagement programs to enhance customer understanding of the benefits of increased choice of energy products. We accept that for the full benefits of competition to be realised, customers need to be empowered by better information and engaged by measures which make the experience of switching easy, attractive to undertake, and timely. Engaged consumers drive efficiency and innovation in the electricity sector by responding to new offerings from retailers. Losing this engagement would result in less effective retail competition and is unlikely to be in the long-term interest of consumers. We believe that the most effective and sustainable response to promote engagement is through policies that promote understanding to enable customers to obtain better deals.

Origin supports the Commission's proposal to examine how offers and discounts are marketed in the ACT and other jurisdictions and the application of initiatives to improve transparency and comparability in other jurisdictions. Origin agrees with the Commission that a range of initiatives in other jurisdictions have only recently been implemented or proposed and have therefore not been effectively market-tested. Origin cautions against the premature application of such initiatives in the ACT and propose that a measured approach be taken to the introduction of proposed initiatives to ensure that potential unintended consequences are minimised. In particular, it is important to assess the impacts of proposed initiatives on consumer behaviour prior to considering their implementation in the ACT. For example, it is important to not over-complicate messages, or else customers may not engage at the level most appropriate to them.

Origin considers that allowing standing offers to act as reference prices is an effective means of enhancing comparability of offers for consumers. As indicated by the Commission, the requirement to advertise discounts from a common reference point is a key feature of both the DMO and VDO. The application of a reference price allows consumers to directly compare retail offers and encourages retailers to present their "best" offers. Origin is a long-standing supporter of reference pricing in the ACT and considers that the regulated standing offer represents a suitable reference point. Further, we consider that the usage calculations adopted by the AER in establishing its DMO should be utilised by the Commission to set an annual reference bill. While Origin acknowledges that a reference bill may not be perfect given the variation in customer usage patterns, we consider that it at least provides some form of reference point against which market offers and retailer discounts can be compared by customers.

The application of reference prices will complement initiatives already put in place to support comparability and the presentation of prices offered by retailers. These initiatives include:

- the AEMC Preventing Discounts on Inflated Energy Rates Rule which prohibits retailers from including discounts in market retail contracts where customers would definitely be worse off under the undiscounted market offer than under the standing offer;
- the AER's revised Retail Pricing Information Guidelines which provides guidance on how retailers should present pricing information including percentage discounting;
- AER's Benefit Change Notice Guidelines which requires retailers to notify a small customer through a benefit change notice when their market retail contract benefit is expiring or changing; and
- AEMC Advance Notice of Price Change Rule to apply advance notice to all small retail energy consumers on market and standing offer contracts for both price increases and decreases.

Origin also supports the Commission's review of other existing measures to improve transparency and comparability such as the consumer data right and comparison websites. In this regard, Origin notes that the consumer data right model is being progressed by the ACCC. We are also supportive of recent calls from the ACCC to progress a mandatory code of conduct for energy comparator websites to improve the presentation of information to consumers[9].

If you have any questions regarding this submission, please contact Gary Davies in the first instance at [redacted].

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy
[redacted]

[9] ACCC, Inquiry into the National Electricity Market, August 2019, p. 72.