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Dear Ms Jolly,

**RE: Default Market Offer Prices 2021-22 Draft Determination**

Origin Energy appreciates the opportunity to provide a submission in response to the Australian Energy Regulator's (AER) Default Market Offer Options Paper on the methodology to be adopted for the 2022-23 determination.

The purpose of the DMO is to act as a reasonable fall-back position for those not engaged in the market whilst also allowing scope for continued competition in retail offers.

Since the introduction of the DMO, both standing offer prices and market prices have decreased. In addition, customer satisfaction with their retailers and the market more broadly has improved. There is clear evidence that the current DMO method is meeting its policy objectives.

On this basis, there is no compelling reason to change the current indexation method for calculating the DMO.

Notwithstanding, we agree it is good regulatory practice for the AER to examine whether the current approaches to calculating input costs within the current method could be refined or improved.

In terms of retail costs, the main objective of the ACCC retail costs was for market monitoring purposes, not for developing regulated prices. As a result, we do not believe the ACCC costs easily lend themselves as a cost input. One of the key challenges for the AER if it uses the ACCC costs will be understanding how different retailers have allocated costs across their activities. This is especially important as the AER will need to determine a single representative cost for all retailers. We are concerned that this calculation will involve more judgment than objectivity and will increase the risk of regulatory error. We believe introducing such risk is unnecessary given the performance of the current method.

We also strongly support the AER's suggested approach for the inclusion of smart meter costs in DMO 4. We think the inclusion of these costs is appropriate as they are already significant and are expected to grow as the policy impetus for greater penetration of smart meters increases.

Origin's views on these issues and other elements of the AER's draft decision are set out below.

**Question 1: What is the most appropriate approach to estimating retail operating costs under a cost based approach?**

The AER has stated that the reason it is reviewing its method is to ensure its overarching approach and assumptions remain appropriate to meet the policy objectives and continue to meet stakeholder expectations.

The policy context for the DMO is set out in the ACCC 2018 Retail Electricity Pricing Inquiry (REPI). The ACCC stated that the purpose of the DMO is to act as a reasonable fall-back position for those not engaged in the market whilst also allowing scope for continued competition in retail offers.

There is no evidence that the current method is not achieving the policy objective. We see no compelling reason to move away from the indexation approach at this point in time. We discuss this evidence in our response to Question 4.

**Question 2: What information should we have regard to in estimating retail costs?**

We are concerned at the AER's proposed use of ACCC retail costs. Based on Origin's assessment of previous ACCC retail cost estimates we identified a lack of transparency in how the data was processed and then applied to establish the costs that were reported. We noted that cost estimates varied significantly between retailers and were largely unable to understand the cause of the variance. Further, we found that the reported ACCC data departed significantly from our publicly reported costs. We believe that this highlights that there are material differences in how retailers and the ACCC classify costs which will distort true year on year movements.

Further, because the ACCC express retail operating costs as an average, it is difficult to determine which costs have been included or excluded. Cost categories and the composition of these categories can vary significantly between retailers, and retailers often develop cost estimates and allocation methods on a different basis depending on the purpose of the underlying cost.

The difficulties associated with determining robust, consistent, and reflective retail cost estimates across retail businesses has the potential to significantly undermine the development of an appropriate retail cost estimate. Unlike an indexation method, the risk of error under a cost based approach can have significant consequences for the financial sustainability of some retailers and consequently the degree of retail market competitiveness. Any adverse impact on the retail sector can also have adverse customer outcomes.

On this basis and given the demonstrated effectiveness of the current indexation approach in achieving the DMO policy objectives, we consider that the AER should maintain the current approach to determining retail costs.

**Question 4: Is the DMO protecting customers from unjustifiably high prices? If so, why?**

To move away from the current method, the AER ought to demonstrate that current market or DMO prices are unreasonable and that the DMO has had an adverse impact on competition.

Since the introduction of the DMO, there have been multiple reviews and studies into pricing trends and how customer satisfaction with the electricity market has changed. The findings of these reviews have been consistent: since the introduction of the DMO, customer satisfaction with both the performance of the market and the price they are paying has improved; and standing and market prices have decreased.

Specifically, as part of its review of the DMO Code, the Department of Industry, Science, Energy and Resources (DISER) found that consumers tended to feel mostly positive about the policy. Based on its customer survey it found that 61% of residential customers and 72% of small-business customers give

the policy a rating of 7 or more out of 10. The main reason given was because it helped by making it easier to shop around.<sup>1</sup>

In its customer survey, Energy Consumers Australia (ECA) found that 57% of household consumers now say they are satisfied with the value for money of electricity, up 4% over the past year and 22% since the same point in 2017. Amongst small business consumers, satisfaction is up 4% over the past year and 16% since December 2017 (60% are satisfied). Consumer confidence has also improved. While still relatively low, the ECA found confidence amongst household consumers that the market is working in their interests is the highest it has ever been.<sup>2</sup>

The AER also noted these findings in its *State of the Energy Market 2021*. Specifically, that between June 2018 and February 2021, median market offer prices fell by 8–16% in Queensland, 10–18% in NSW, 7–10% in Victoria, 19% in South Australia and 4% in the ACT. Changes in the cheapest market offers in each region were even more pronounced over this period, except in Victoria. The lowest market offer price reduced by 8–22% in Queensland, 17–22% in NSW, 26% in South Australia, 4% in the ACT and 8% in Tasmania. The cheapest market offer in Victoria increased by 1% in one network area and reduced by up to 6% in the other 4 network areas.<sup>3</sup>

The ACCC in its most recent Inquiry into the National Electricity Market Report found that the introduction of the DMO has protected customers on standing offers by bringing those prices down. The ACCC noted that between 2018 and 2019 prices for standing offer customers decreased significantly (4.3% for residential and 7.5% for small business) and by a greater amount than for market offer customers. Between 2019 and 2020, the effective price of residential standing offers again declined more than for market offer customers (6.3% for standing offer customers and 4.4% for market offer customers).<sup>4</sup>

These findings demonstrate a common conclusion – that following the introduction of the DMO unjustifiably high standing offer prices have been eliminated. Moreover, the DMO has not had a detrimental impact on competition and those most active in the market are still able to obtain significant discounts.

For these reasons we believe there is compelling evidence to retain the current approach.

#### **Question 5: What factors are relevant in considering whether a price is excessive?**

An assessment to determine if prices are excessive and how to respond to such a finding is complex and will require the consideration of multiple factors. The first and most critical is to provide an unambiguous and well understood definition of “excessive” and the process the AER will undertake in making this decision. This will involve a judgment on what efficient costs are for a retailer, what level of return above these costs is “excessive”, and over what time period.

An assessment of cost needs to be made in the context of the “efficient” costs to enter and exit the market. If too strict an interpretation of costs is made (e.g. marginal costs), this will not allow a retailer to recover their sunk or fixed costs and may misrepresent what is efficient over time.

In terms of defining excessive, this requires a calculation of the difference between the actual price of the electricity service in question and the “efficient” cost of delivering the service. If the actual price is higher than the “efficient” cost, then a judgment needs to be made whether the difference is unreasonable *and* a detriment to consumers.

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<sup>1</sup> Department of Industry, Science, Energy and Resources (DISER), Competition and Consumer (Industry Code – Electricity Retail) Regulations 2019 Post-Implementation Review, p. 9.

<sup>2</sup> Energy Consumers Australia, Energy Consumers Sentiment Survey, December 2020, p. 8.

<sup>3</sup> AER, *State of the Energy Market 2021*, p. 266.

<sup>4</sup> ACCC, *Inquiry into the National Electricity Market*, May 2021 Report, p. 8.

This involves multiple challenges. The first is defining the product. For example, will the assessment apply to all market products or certain products, to all retailers or only certain retailers, or limited to a specific network. In this regard, the concept of “efficient” cost ought to apply to the price assumed under conditions of long-run competitive equilibrium.

In making this assessment, the AER needs to consider the existence of entry barriers and market power. For example, are the barriers sufficiently low and is there sufficient competition for the market to be self-correcting and over what time horizon could this occur. This will require a more dynamic view of the market rather than a point in time assessment as well as a judgment about what is a reasonable time for self-correction.

This involves a decision regarding what is a “reasonable” price as opposed to an “excessive” price and the costs of intervention versus the benefits (i.e. regulating prices down may inhibit the entry and/or expansion by competitors).

Imposing this level of perceived precision carries significant risk of regulatory error. As noted in our response to question 4, we are seeing effective competition, lower prices, and improvements in customer satisfaction.

We believe the current indexation method results in a DMO that is not excessive and supports the effective functioning of the market.

**Question 6: What other factors should we consider when assessing the DMO allowance required to incentivise customers to engage in the market?**

Since the introduction of the DMO, customer switching rates have dropped. However, we do not consider this to be a negative outcome of the DMO and Reference Price. Previously, customers were engaging with some retailers based on inflated discounts where the actual benefits did not match their original expectations because of the inflated base rate.

What the DMO has achieved is providing an outcome for customers where their actual benefits more closely match their perceived benefits.

While the DMO has eliminated inflated standing offers, policy makers need to remain mindful that customers need an incentive to engage with the market. The lower the DMO and the greater the compression in discount rates, the higher the likelihood that customers will consider the reward versus effort from engaging in the market as being not worth it – meaning switching rates may fall further. Lower prices also make energy a lower consideration for customers. This does not necessarily imply a policy failure, rather customers are making informed decisions.

We believe the opportunity for further improvements does not sit with the calculation of the DMO but in the language and presentation of the reference price. This can be best achieved by ensuring the language and content requirements of the Code are as simple and as user friendly as possible.

We believe these are matters for DISER in its review of the DMO Code.

We also contend that Government as policy owner ought to consider a broad-based education campaign. This responsibility cannot simply be left to retailers; it must be a joint and coordinated effort between Government, regulators, and industry.

**Question 7: Should the margin above efficient costs in the DMO price be consistent across all DMO regions and customer types?**

Margins can vary by region for many reasons including risk, marketing strategy, and customer longevity. While margins clearly differ between DMO regions, these potentially balance out in aggregate over the regions and can also vary considerably between individual retailers depending on underlying retail cost structures. Further, larger margins potentially facilitate increased competition, with the result that margins in these regions will be reduced over time as retailers aggressively compete for customers.

This outcome is consistent with the evidence to date regarding the reduction in median market offers compared to the DMO.

Attempting to set a consistent margin can have adverse consequences for customers in some regions with little reference to the actual cost of serving standard offer customers. We consider it would be an undesirable outcome for a universal margin that resulted in a higher DMO.

**Question 9: Should we continue indexing the current residual? Question 10: What are the benefits and disadvantages of this approach?**

As noted in our response to Question 4, since the introduction of the DMO, both standing offer prices and market prices have decreased. In addition, customer satisfaction with their retailers and the market more broadly has improved. On this basis, the current approach is meeting the policy objectives.

Furthermore, not only have outcomes to date been positive, but the index approach also provides a relatively stable movement in prices from one decision to the next.

**Question 11: How could the step change framework be improved?**

We consider a key deficiency in the step change framework concerns the data to be provided. The AER has previously denied cost allowances because of insufficient/limited data e.g. Consumer Data Right and 5 minute settlement regulatory changes. While it can be clearly demonstrated that an event/regulatory obligation is required to be implemented, it is often the case that the actual cost impact can be difficult to estimate. This does not deny that the requirement will be fulfilled, and costs incurred, the challenge is in accurately predicting associated costs prior to commencement of the task. This can be difficult to demonstrate and with no provision for a true-up after the costs have been incurred, there is typically limited scope for a retailer to either present a compelling case for a step change or to ultimately recover costs.

We consider that the AER should explain the type and quality of data likely to be acceptable under these conditions of inherent uncertainty. Given that these obligations are required to be fulfilled and there are typically specified project dates and milestones, it is clear that costs will be incurred. The fact that these costs may not be able to be predicted with a degree of certainty should not deny consideration for a step change allowance.

**Question 12: Should we perform an adjustment to reflect movement in retail costs and, if so, should this be performed on an annual basis?**

Origin considers one of the main issues with using the ACCC cost data is the treatment and allocation of certain costs. Different retailers allocate costs differently and, in our experience, the ACCC also treat costs differently to retailers. For example, the ACCC has not included “other” costs in its assessment of NEM wide retail costs. The ACCC note this exclusion in footnote 473 from the REPI which states ‘Retail costs presented in figure 10.1 do not include ‘other costs’ that some retailers reported in 2013–14, 2014–15 and 2015–16, which are included in figure 1.37 in chapter 1.’

The ACCC has not explained the basis for the exclusion of these “other” costs. When Origin submitted its data to the ACCC in line with the ACCC’s request these other costs included the costs of performing core retail functions like retail management and administration costs, credit and collections operating costs, and correspondence. We believe this was erroneous and does not fully represent how costs are moving year on year.

As stated, we are also concerned about how the AER can take different retailers’ costs that have been derived using different cost allocation methods and derive a single rate for the purposes of a year-on-year movement. We believe there are significant risks of regulatory in such an approach.

**Question 13: How long should we retain the methodology we adopt in this review?**

Given the relative infancy of the regulatory framework, we believe it would be prudent to adopt a shorter fixed method period to ensure any adopted framework remains sufficiently adaptive and fit for purpose. For this reason, we support a review period of three years.

**Question 14: Is our existing wholesale cost forecasting methodology, in terms of its approach and considerations (modelling of demand and supply, spot price, hedging etc.) complete, appropriate and representative of costs to supply energy?**

Origin supports the retention of the current market based approach to forecast wholesale costs. We also agree that the key methodological variables are the assumed hedging strategy of the representative retailer and the nominal margin for error in the AER's forecasts.

We note that load profiles have changed because of increased solar penetration. We believe that the average profile for residential customers is starting to become a lot peakier in the last two years, presumably driven by solar penetration and COVID-19. As a consequence, the cost of hedging is likely to increase as the load factor deteriorates with retailers bearing more under/over hedging as flat swap products are used to hedge a more sculpted load shape. Specifically, we are faced with a situation where we are buying more caps due to the shape with lower cap payouts.

In addition, the lower consumption volume associated with greater PV penetration will also affect retail cost recovery – a higher unit price being required to recover the same operating costs and margin allowance over a reduced volume.

On this basis, we consider that the recent load data provides a more accurate representation of forecast load. We consider the ESC ought to place more weight on more recent data and consider a 3-year history to account for this change in load profile.

**Question 15: Should our existing assumed hedging strategy be adjusted to allow for a higher level of spot market exposure? And if so, what is the appropriate level of exposure? (please also consider this question in conjunction with Margin for forecast error discussion below)**

The AER's current approach assumes a retailer would start building their hedge book from the date of the first contract trade, as opposed to setting arbitrary cut-off dates and book build periods.

We support this approach. 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 believe it is highly unlikely that an efficient hedging strategy would involve a retailer accessing hedge markets from time to time when conditions are considered favourable and not seeking to hedge prices at a time dictated to by each regulatory decision.

We believe the existing approach appropriately reflects the practices of a risk averse hedging strategy. retailer.

**Question 16: Does our assumption of a retailer building their hedge book from the time of the first trade recorded by ASX Energy, remain appropriate, or is a shorter period justified? What is an appropriate period and why?**

Origin agrees with the AER observation that a longer hedge book smooths out price fluctuations. We believe stability in regulated prices is a desirable attribute of any regulatory price setting. For example, we note the AER often applies revenue smoothing to its network pricing decisions for this very reason.

A shorter book build period will increase the magnitude of increases or decreases in forecasts between years, compared to a longer period. We also consider that the AER ought to be mindful that shorter periods will result in observing prices where there is less liquidity. We note that there is appropriate



liquidity in contracts more than 12 to 18 months before a risk period. On that basis adopting a shorter period would result in drawing outcomes from a less liquid market.

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).

**Question 17: Does the 95th percentile hedged WEC estimate remain appropriate, in context of the hedging strategy? What alternative percentile could be applied and what would the justification be?**

We retain the view that the 95<sup>th</sup> percentile of the simulated wholesale energy costs from its hedge model represents an appropriate approach to assessing risk. We stress that any strategy needs to sufficiently account for volatility and the linkage between high electricity pool prices and high demand.

Moving away from the 95<sup>th</sup> percentile will require the AER to consider a volatility allowance to compensate retailers for the residual risk to which they are exposed, even when they contract at the conservative point. We believe adopting this approach introduces unnecessary complexity and carries the risk that the volatility allowance understates the level of risk costs associated with the AER's expected exposure. Given these issues, we consider that there is no compelling evidence or reason for the AER to change its approach.

**Question 18: Do you agree with the appropriateness of our environmental cost forecasting methodology for DMO 4?**

We generally support the AER's approach. To the extent that the Clean Energy Regulator does not release its final decision on the STP and RPP in time for the AER to incorporate these into a final decision, we believe the AER ought to apply a true up of the historic differences.

With respect to the liability percentages, we continue to support the AER (through its consultant) applying judgement where small-scale technology percentage values are non-binding.

**Question 19: Should the calculation of network costs for residential customers continue to be based on flat rate tariffs only? If yes, as what level of TOU tariff penetration should this approach be reassessed?**

Given that the vast majority of DMO customers are on a flat tariffs, we believe retaining the calculation of network customers based on flat rate tariffs is a pragmatic approach.

**Question 22: Should we assess metering costs separately from network costs?**

See response to Question 24.

**Question 23: Do you agree with our preferred position to not true up network costs in calculating the DMO price?**

We agree that the requirement for a potential true-up of network costs will be reduced if the DISER proposed amendments to the DMO Code are forthcoming. These amendments are aimed at better synchronising the most recent network pricing determination with the timing for the DMO. Similarly, we support AER initiatives to streamline internal processes for approving the DNSPs' annual pricing proposals.

We consider it critical that network costs are passed through to retailers in full. Retailers have no influence over network costs; they are effectively a pass-through for retailers. It is unreasonable for retailers to bear any cost burden (or receive a cost benefit) associated with these costs. To the extent there is a misalignment we consider that the AER ought to strongly consider a cost true-up for network costs.

**Question 24: Should the DMO 4 methodology include an allowance for advanced meter costs? And if so, is the proposed approach above viable to calculate and account for its cost?**

We support the inclusion of an allowance for advanced metering costs in the DMO. While DMO customers are less likely to proactively request the installation of a smart meter, these customers will often have a smart meter installed because of family failures. As more meters progressively reach the end of their useful life and as more meter “family failures” occur, the number of DMO customers with a smart meter will increase.

Furthermore, we note that the AEMC’s review of the regulatory framework has heightened the policy intent for a greater penetration of smart meters across all classes of customer. In our response to the review, we identified the failure to incorporate an advanced metering allowance in the DMO as both an impediment to the roll out program and the realisation of the full benefits from smart meters.

We support an approach to metering cost inclusion in the DMO that recognises that not all DMO customers are likely to have advanced metering at this time. We consider that the AER’s proposal to incorporate a weighted cost for the region, based on the proportion of customers with advanced meters is both reasonable and equitable. Such an approach is relatively easy to implement and can be readily updated as the roll out of advanced meters progresses.

**Question 25: Do you support our use of DNSP data, cross-checked with other sources, to determine residential annual usage?**

Origin supports the proposed review of usage amounts to ensure these remain representative. We consider that the proposed use of updated consumption data from DNSPs to identify typical usage, cross-checked with other sources, is appropriate. It may also be appropriate to review this data on a regular basis to ensure it remains reflective. This is particularly relevant as the economy moves out of the Covid-19 period and the potential for the home/workplace balance to adjust toward pre-Covid-19 usage patterns.

**Question 30: Do you support updating the usage profiles by averaging across 3 years of usage data?**

Given the impact of Covid-19 on usage profiles, we consider it appropriate to adopt a 3-year average of usage patterns. We propose the 3-year average be regularly updated to reflect the changing impact of Covid-19 on the economy and particularly the structure of working arrangements.

If you would like to discuss any aspect of this submission, please contact Sean Greenup on (07) 3867 0620 / [sean.greenup@originenergy.com.au](mailto:sean.greenup@originenergy.com.au) in the first instance.

Yours sincerely



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