17 March 2022

Ms Stephanie Jolly
General Manager, Market Performance
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Email: DMO@aer.gov.au

Dear Ms Jolly,

RE: Default Market Offer Prices 2022-23 Draft Determination

Origin Energy appreciates the opportunity to provide a submission in response to the Australian Energy Regulator's (AER) Default Market Offer Prices 2022-23 Draft Determination.

A central element of robust regulatory decisions is that they provide clarity and predictability with clearly defined objectives. One of the key objectives of the default market offer (DMO) price cap is to allow retailers to recover their efficient costs of providing services, including a reasonable retail margin.

Origin has initial concerns that the AER has not made available sufficient detailed analysis, or the nature and content of information it has relied upon, with respect to its calculation of wholesale costs and its proposal to change methodology from the index approach to a cost build up. The limited information provided by the AER in its draft decision about the reason for, and basis of, its approach to these and other matters makes it difficult for Origin to fully assess or comment on the AER's decision.

Origin requests the AER to provide additional information in relation to these matters to allow it and other retailers to fully consider and provide views on them prior to the AER making its final decision. Further, Origin believes it is incumbent on the AER to do so – having regard to proper principles of accountability and transparency in regulatory decision making.[1]

Collectively, these requirements for good regulatory practice are best captured by the Australian Competition Tribunal:[2]

> *…a decision maker like the AER is required to deal with the substantial points raised, make findings on material questions of fact, refer to the material upon which findings are based, and provide an intelligible explanation of the process of reasoning leading to the ultimate conclusion.*

To the extent that Origin is able to comment on the AER's proposed approach on the basis of the information included in the draft determination, we have set out our response below (and have identified where we seek further information or clarity).

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[1] See for example the Queensland Competition Policy, Statement of Regulatory Pricing Principles, August 2013; Henry Ergas, Regulatory Risk, a paper prepared for the ACCC Regulation and Investment Conference, Manly, 26-27 March 2001; Utility Regulators Forum, Best Practice Utility Regulation – Discussion Paper, 1999; AEMC, Advice on Best Practice Retail Price Regulation Methodology, September 2013; and Australian Energy Regulator, Better Regulation: An Integrated Package, 13 May 2013
[2] Energy Australia v Australian Competition Tribunal (2009) ACompT 7 at [16].

Wholesale Costs

Margin for Forecast Error

Wholesale energy costs are one of the most significant sources of regulatory risk for regulated electricity retailers. This is because of the volatility of wholesale markets, the fixed price nature of retail products and the risk of a regulatory decision that will result in a retailer not recovering their costs.

The AER has determined that several aspects of the DMO hedging assumptions are inherently cautious and, as a result, it has proposed a change to the margin for forecast error from the 95th percentile to the 75th percentile of outcomes. We do not support this decision and consider the AER has only provided limited analysis to support its decision. We consider that the AER should demonstrate what specific elements of ACIL's proposed hedging strategy it considers are inherently cautious and why the AER's assumptions regarding risk and hedging are preferable to those of ACIL.

In previous decisions, ACIL Allen (ACIL) noted that the 95th percentile was chosen to minimise the chance of understating the risk associated procuring wholesale electricity to serve retail load.[3] In addition, ACIL noted that estimating the wholesale energy cost (WEC) inherently involves a degree of uncertainty and the use of the 95th percentile helps to minimise the risk of underestimating the true value of the WEC.[4]

ACIL has not explicitly endorsed the adoption of the AER's 75th percentile, stating that '…the AER has determined that the 75th percentile WEC be adopted'.[5] We note also that ACIL has not altered the assumed hedging strategy in response to the AER adopting the 75th percentile WEC.[6]

Under the AER's proposed change, the move to the 75th percentile implies that retailers will not recover their wholesale cost for 25 per cent of circumstance under the assumed hedging strategy. In considering this potential outcome, it is prudent to observe recent outcomes in the United Kingdom where nearly half of retailers have recently failed. On this basis, we question the AER's assumption that hedging to manage a 1 in 20-year outcome is "overly risk averse".

Pool Price Simulations

One of the key drivers in ACIL's calculation of the WEC allowance is the forecast spot price. ACIL estimate forecast spot prices using its proprietary *PowerMark* model. Due to its proprietary nature, stakeholders have not been afforded an opportunity to have visibility of the detailed calculations within the model including independent input variables.

Nevertheless, we believe a key requirement from ACIL's modelling is that it reflects market expectations. As we understand, the ACIL model uses demand and renewable energy resource traces, and power station availabilities as inputs. However, it is not clear how generator fuel costs are factored into the model.

This is especially relevant as we have seen gas and coal prices increase significantly over recent months, largely driven by global supply factors. This is leading to significant increases in generation fuel costs and in turn electricity spot prices.

As demonstrated in diagram 1, gas spot prices at Wallumbilla have increased from about $6/GJ in FY20 to about $10/GJ likely reflecting higher international LNG prices which typically affect domestic gas prices via a higher LNG netback price – although at present East Coast prices remain disconnected from JKM we expect these should align closer over time.

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[3] ACIL Allen, Default Market Offer 2020-21 Wholesale energy and environment cost estimates, 10 September 2019, p. 25
[4] ACIL Allen, Default Market Offer 2020-21 Wholesale energy and environment cost estimates, 28 April 2020, p. 16.
[5] ACIL Allen, Default Market Offer 2022-23 Wholesale energy and environment cost estimates, 23 February 2022, p. 18.
[6] Ibid.

Diagram 1: Gas Spot Prices
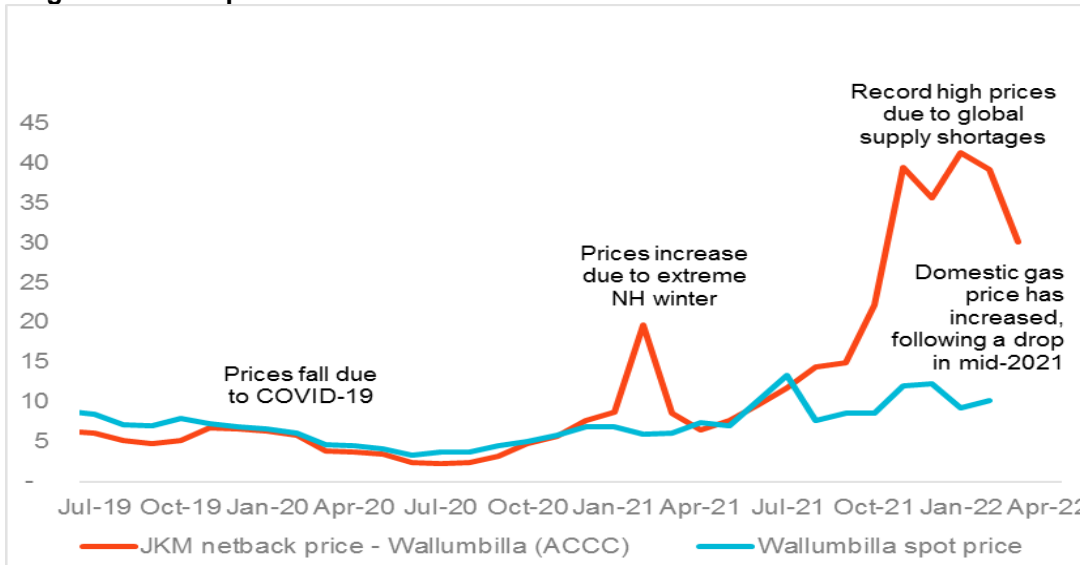
Furthermore, diagram 2 shows a pronounced uplift in coal prices since late 2021, and most notably since the start of the Russia/Ukraine conflict. Given the significance of Russia's export volumes to the European thermal coal market we expect to see export prices continuing to track at record high levels driven by a tight global energy market. Not only will the increased price have an impact on domestic coal generation costs, but we also see a risk of coal constraints leading to lower generation output.

Diagram 2: Newcastle Thermal Coal Prices
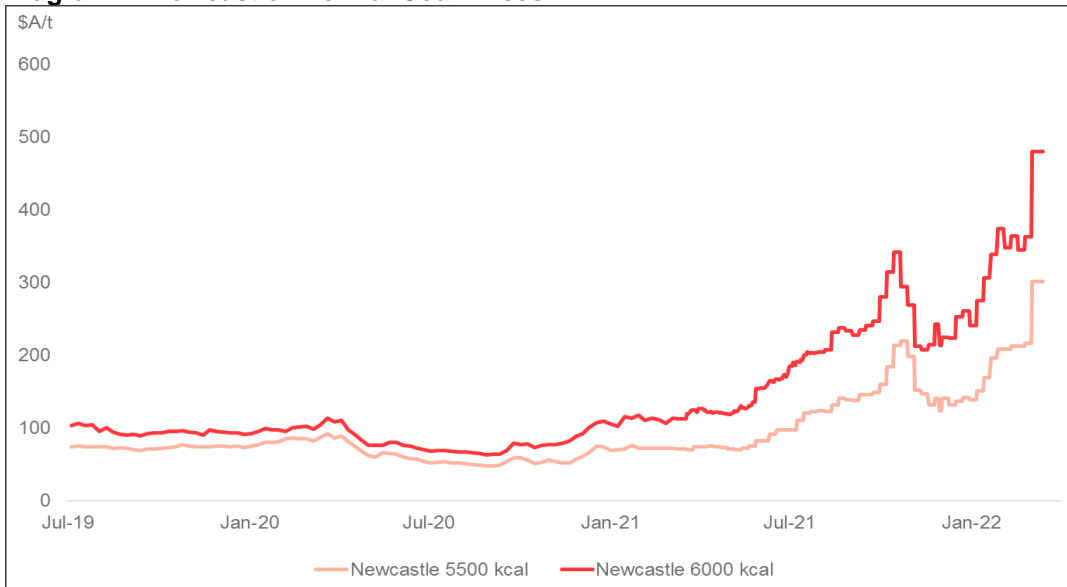
Considering the significant uplift in these generation input costs and the existing market uncertainty for these commodities, we consider that ACIL's draft distribution of energy prices appear low. For example, based on figure 4.20 in ACIL's report, the Queensland chart implies an average trade weighted price below $60/MWh with only approximately 2 per cent of simulated prices reaching the current forward

curve.[7] In our view, the current market dynamics are expected to continue well into 2022, with all market price indicators suggesting an electricity spot price in the $60/MWh-$70/MWh range is unlikely and significantly higher prices are likely to eventuate. We believe this point is well highlighted in the latest base contract prices shown in diagram 3.

Diagram3: FY23 Base Contract Prices (as at 14 March 2022)
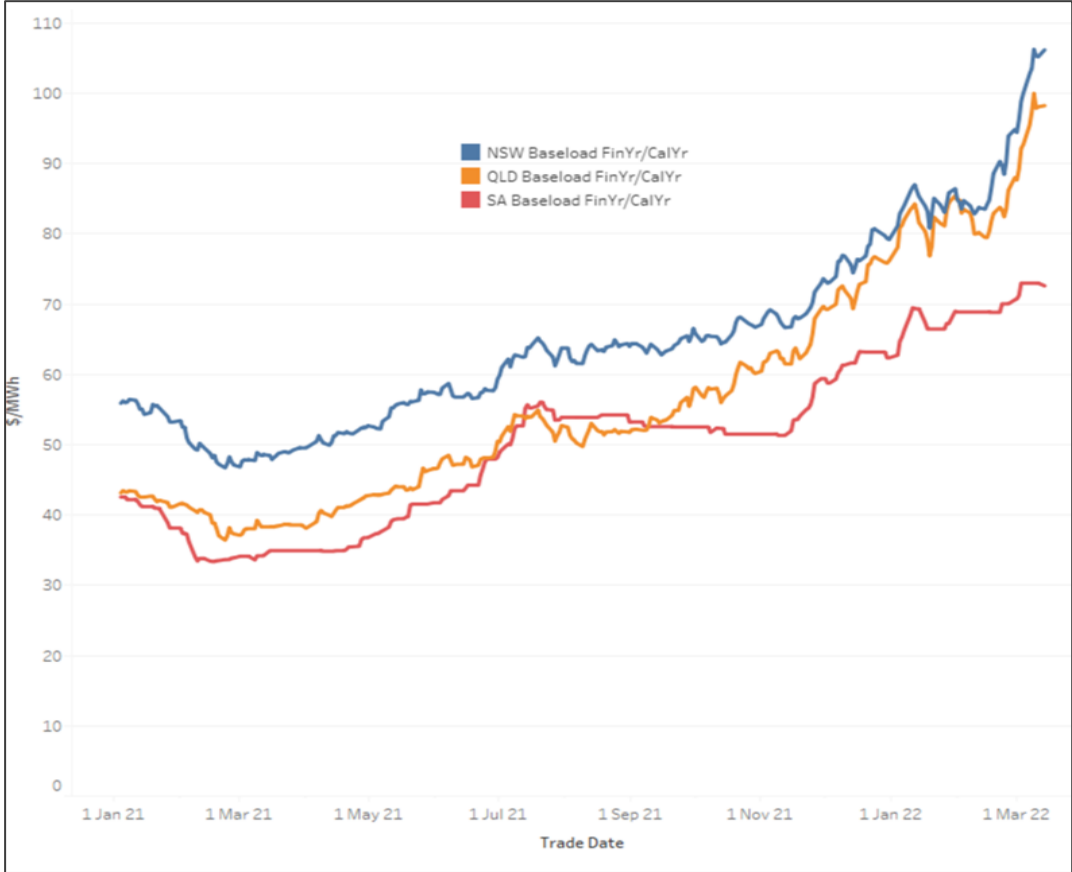
For these reasons, we request that the AER and ACIL provide a clearer explanation of the relationship between input costs and the spot price in its modelling calculations. We also consider that ACIL need to explain how well its predicative modelling captures the current unstable global supply events which we consider to be an outlier in its modelling series. This is vital to ensure that ACIL delivers a recommended WEC that allows retailers to recoup their efficient costs.

Understanding ACIL Modelling

Unlike in previous decisions, Origin has had difficulty in reproducing ACIL's outcomes with the information provided. For this reason, we are seeking further information to enable us to better understand how ACIL has arrived at its recommendations. We have included a request for further information at Attachment A.

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[7] 10/3/2022 ASX energy quoting settle FY23 base QLD strip $100.00 and FY23 cap strip $20.93, implied energy FPC is $79.07MWh

AEMO Direction Costs

The AER has indicated that it will include prudent reliability and emergency reserve trader (RERT) costs in its final determination.

AEMO activated the RERT mechanism in Queensland on 1 February 2022. The cost of this event was $39M.

As Origin understands, the AER allows the recovery of RERT costs based on the cost of the RERT activation divided by the total energy requirement in the affected region. We believe this method would result in Origin incurring a significant under-recovery of its costs.

For example, taking a Queensland total load of 53TWh and a RERT cost of $39M results in a recovery allowance of $0.75/MWh.

However, in Origin's case its allocated RERT cost was $11.6M with $3.8M relating to C&I customers giving it a net residential and SME liability of $7.8M. Origin's Queensland load is 3.6TWh. If the recovery rate was set at $0.75/MWh, Origin would recover about $2.5M leaving it with an under-recovery in the order of $5.3M.

We believe the use of the total Queensland load is not appropriate for calculating a RERT cost for residential and SME customers. The total Queensland load includes the load of LNG customers and other industrial and commercial customers. This creates an incorrect denominator in the AER's calculation.

The best way to address this would be for the AER to remove the C&I load and cost data from the calculation. As a result, this will calculate a RERT cost representative of residential and SME customers.

Given the materiality of the costs involved, we strongly encourage the AER to consider these adjustments to its method or make other adjustments that will allow all retailers with a reasonable opportunity to recover their RERT costs.

Environmental Costs

Origin supports the approach applied by ACIL with respect to renewable energy costs. We agree that non-binding STP values do not properly capture the final binding STPs and are leading to estimates that are likely to be too low. As a result, we support this information being revised for the final determination when the CER has published the final binding parameters.

Retail Costs

Change in Methodology

For the purposes of this draft determination, the AER has decided to change its cost setting approach from the existing indexation method to a cost build-up approach.

The AER has stated that, in its view, a cost build-up approach incorporating a consistent retail allowance across all regions best achieves the DMO policy objectives. It also considered that this approach would provide greater transparency on the cost drivers in the market as well as addressing concerns with the step-change framework because actual changes in retail costs will be included in future DMO determinations.

There are two issues that require consideration: 1) has the current indexation method met the DMO policy objectives; 2) what evidence is there for a change in method; and 3) is a cost stack method using ACCC costs consistent with the DMO policy objectives.

In terms of the policy objectives, the ACCC stated in the REPI that the DMO should not be the lowest price, or close to the lowest price, in the market. It is a fallback offer for those that are disengaged or require its additional protections and ideally, it should only be used by a small number of consumers. The ACCC went on to state it does not, therefore, consider that the DMO should not be determined by using a cost-based, building block methodology but by an indexation method.[8]

The AER's first DMO using the indexation method saw annual reductions of $118 to $181 to the median standing offer price for residential customers. For DMO2 there were further reductions of $109 in the SAPN region and $62 in the Energex region. The continued use of the indexation approach in DMO3 saw further reduced prices with reductions of between $53 and $102 in NSW; $53 in Energex; and $116 in the SAPN region.[9] The reductions in the median standing offer price are consistent with the policy objective of protecting consumers from higher prices. In its DMO3 decision, the AER concluded 'the DMO price continues to meet the policy objectives' and '[t]his remains the approach best suited to achieving the DMO policy objectives, while also providing consistency and stability for stakeholders'.[10]

With respect to the objective of maintaining incentives for competition, the AER noted that under the DMO3, competition and innovation is active, even in the lowest margin region of SAPN. It went on to state that it has not seen evidence that the DMO is impacting competition or that retailers have been discouraged from entering the market.[11]

This past experience makes evident that the use of the indexation methodology is effective in achieving these objectives, as was recognised by AER representatives at the AER's public forum on 9 March 2022.

Origin is concerned that the AER is proposing to move from a methodology which has proven to meet the objectives without providing details of:

- the analysis upon which that decision was based;
- the basis on which it has concluded that the proposed approach will achieve the DMO objectives (and its analysis of the risks of not achieving the DMO's objectives as a result of changing its approach); or
- its plans for assessing the effectiveness of the new approach following its introduction.

With respect to the ACCC cost data, as Origin understands this is collected from most retailers. The ACCC clean this data for inconsistencies and errors and derive a 'dollar per customer' measure by dividing revenue and costs by numbers of customers.

As result, this representative cost is heavily biased toward the costs of tier 1 retailers. Given the scale advantages of tier 1 retailers this effectively benchmark the DMO retail costs to those of a tier 1 retailer. As a result, to ensure the DMO affords retailers a reasonable return, the AER needs to carefully consider whether this average cost approach affords all retailer with a reasonable opportunity to recover their costs.

Retail Allowance

It is important that the AER make clear how the single rate allowance is apportioned between the retail margin and the competition allowance. Under the AER's indexation method, the AER did not need to consider this difference because it was implicit in the residual (in an aggregate sense). However, this is

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[8] See Australian Competition and Consumer Commission, Retail Electricity Pricing inquiry – Final report June 2018, p. 249; and Response to AER's Position Paper, 7 December 2018.
[9] Australian Energy Regulator, Default Market Offer Price Determination 2021-22 Final Determination, p. 7.
[10] Australian Energy Regulator, Default Market Offer Price Determination 2021-22 Final Determination, pp. 8-10.
[11] Australian Energy Regulator, Default Market Offer Price Determination 2021-22 Final Determination, p. 50.

not the case for a cost build up methodology. The retail margin is quite separate to a competition allowance, and both ought to be calculated discretely.

For example, the retail margin is not the retailer's profit margin. The retail margin includes those retailer costs that a retailer recovers from its customers on a per consumption basis rather than a per customer basis. Accordingly, the retail margin includes retailer costs as well as a net margin. The AER needs to make clear on what basis it has estimated the margin allowance e.g. whether it is based on estimated returns or EBITDA margin. This certainty is important because it can impact the type of investment decisions that retailers make.

In turn, this will make transparent the value of the competition allowance.

For this draft determination the AER has targeted an aggregate allowance of 10 per cent for residential customers and 15 per cent for small business customers (SME). Origin agrees that a difference between residential and SME margins is appropriate, given that the retail costs of serving customers on small business tariffs are higher than residential customers on average. The reasons include: 1) different customer risk profiles; 2) greater likelihood of default; and 3) the need for different marketing approaches and customer acquisition and retention strategies.

Providing transparency over the derivation of the respective retail allowances is important in that it allows stakeholders to properly test and assess the approach taken and consequent result, as well as allowing for an ex-post assessment of a regulatory decision and allows the regulator to make informed judgment about what aspect of its decision needs to be adjusted in future and why.

For these reasons, we request the AER provide greater clarity over how it arrived at its proposed retail allowance and its proposed method for reviewing its approach in future decisions.

Other Costs
Origin supports the proposal to incorporate advanced meter costs in proportion to the number of customers with advanced meters, noting that this should be updated annually.

Network Costs

TOU Network Costs
The AER stated its intention not to include TOU network costs in DMO prices on the basis that there is little difference between TOU and flat rate network costs, the observation that most DMO customers are on flat rate tariffs and the simplicity of the approach.

Origin agrees that, since most DMO customers are on a flat rate tariff, it is reasonable to base network costs on these tariffs.

Network Cost True up
We note that amendments to the Code proposed by the Department of Industry Science and Resources to extend the date for approving the DMO have not yet been approved by the Treasurer. As a result, the risk of a misalignment between approved network tariffs and the network tariffs used in the calculation of the DMO remains.

In its Draft determination the AER stated that it will continue with the approach used in previous DMO determinations i.e. that it intends to use approved network tariffs for 2022–23 if available, otherwise it will use submitted network prices included in 2022–23 annual pricing proposals. In the circumstances, we agree that this is the best option.

However, we retain our views from the position paper and from previous DMO submissions. If the pricing proposals are delayed by the network businesses, or they are undergoing AER assessment at the time

of the Final Determination, retailers will still bear the risks of any tariff misalignment. This is an undesirable outcome. We believe that retailers should be made whole for any under-recovery.

Closing

We request that the AER make available additional information regarding its analysis, or the nature and content of information it has relied upon, with respect to several key decisions in this DMO.

With respect to the wholesale energy cost allowance, Origin requests the AER provide additional information in relation to what specific elements of ACIL's proposed hedging strategy it considers inherently cautious and why the AER's assumptions regarding risk and hedging are preferable to those of ACIL. We also request the AER provide a clearer explanation of how generator fuel costs are factored into its (ACIL's) spot price modelling calculations.

With respect to retail costs, past experience makes evident that the use of the indexation methodology is effective in achieving the DMO objectives. On this basis, we request the AER provide further information regarding its reasons to change methods including the analysis upon which that decision was based.

Given the magnitude of the costs involved in the Queensland RERT event, we believe it is incumbent on the AER to development a recovery mechanism to allow retailers to recover these costs.

If you have any questions regarding this submission, please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy

ATTACHMENT A

To assist Origin to better understand the AER's (ACIL) WEC outcomes, Origin requests that the AER provide the following information:

A. For each of the modelled patches (Energex, Essential, Endeavour, Ausgrid & SAPN) for both NSLP and CL we request a data table containing the following, for each of the 561 simulations:

- Simulation number for that patch and load component;
- Scenario percentile ranking according to draft WEC for that patch and load component;
- Draft WEC;
- Average annual spot price;
- Energy price (spot component below $300/MWh); and
- Cap returns (spot component above $300/MWh).

Example:

Patch	NSLP/CL	Scenario number	Percentile rank	WEC	Spot	Energy	Cap
Energex	NSLP	1	0	$70.35	$82.10	$40.10	$42.00
Energex	NSLP	2	0.2%	$70.36	$73.66	$53.66	$20.00
Energex	NSLP	3	0.4%	$70.84	$91.25	$90.00	$1.25
…	…	…	…	…	…	…	…
SAPN	CL	1	0	…	…	…	…

This should be approximately 5610 rows, CSV/excel preferred.

B. For each of the modelled patches (Energex, Essential, Endeavour, Ausgrid & SAPN) for both NSLP and CL we request a data table containing the following:

- Hourly profiles for each NSLP and CL for the 5th 25th 50th 75th and 95th percentile WEC outcomes;
- Hourly state and NSLP/CL demand;
- Hourly price;
- Hourly state renewable generation (wind and solar); and
- Hourly hedge portfolio used for draft WEC.

Example:

Patch	NSLP / CL	%tile	Date time ending	NSLP demand MW	CL demand MW	Pool Price $/MWh	State wind supply MW	State solar supply MW	Swap MW	Cap MW
Energex	NSLP	5	1/7/22 01:00							
Energex	NSLP	5	1/7/22 02:00							
Energex	NSLP	5	1/7/22 03:00							
…	…		…							
SAPN	CL		30/6/23 24:00							

Approximately 44k rows.