30 January 2023

Ms Kate Symons
Chair
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne Victoria 3000

Email: VDO@esc.vic.gov.au

Dear Ms Symons,

RE: 2023-24 Victorian Default Offer – Consultation Paper

Origin Energy (Origin) appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) Consultation Paper for the 2023-24 Victorian Default Offer (VDO).

The setting of this VDO comes at a tumultuous period in energy markets as the unprecedented and significant increase in wholesale market volatility is set to place significant upward pressure on tariffs. To maintain the integrity of the retail market during periods of price volatility, the regulatory framework must allow retailers to appropriately manage their financial risks. This is best achieved when there is a consistent and predictable regulatory framework.

Origin generally supports the ESC's decision to maintain its existing method to calculate the VDO for 2023-24. However, we are concerned that the increased wholesale price volatility has increased the risk that actual efficient wholesale costs may fall outside of the range of the ESC's modelled outcomes. If this were to occur, retailers would not be able to recover their efficient costs. We believe it is incumbent on the ESC to ensure that its method produces outcomes that are achievable.

In addition, the period of market suspension and administered pricing in 2022 resulted in significant market interventions, the cost of which will need to be recovered from customers. It is likely these costs will be material, but the timing of when all costs will be known may occur too late for the ESC to include them in this VDO. If this occurs, an allowance for working capital should be included in the VDO to enable retailers to fund their holding costs until full recovery in future VDO decisions.

In terms of the ESC's intent to revisit the approach for escalating retail costs, we believe the CPI provides transparency and simplicity. Its continued use will not result in a loss of precision, and it will continue to provide regulatory certainty and minimise the potential for regulatory risk.

Additional commentary on these and other matters contained in the ESC's Consultation Paper is provided below.

Wholesale Energy Costs

We have previously raised concerns that the ESC's approach of adopting the 50th percentile from the distribution of estimated wholesale energy costs (WEC) may increase the risk that retailers will not recover their efficient costs. Specifically, the ESC's approach means that assuming a symmetrical distribution of outcomes, there is a 50 per cent chance it is underestimating the value of the WEC.

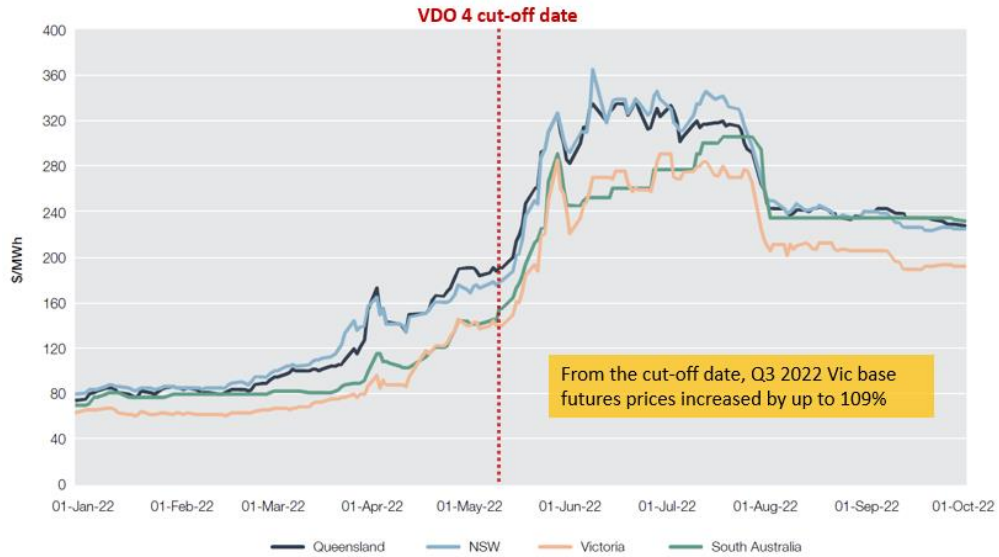
Under its approach, retailers are compensated for the higher risk associated with choosing the median simulated year with a volatility allowance. The ESC's approach assumes that there will be decisions where the estimated WEC will exceed the actual WEC and times when it will fall short. Over the long run, and with the inclusion of the volatility allowance, retailers will be made whole. However, this only holds if the actual WEC falls within the distribution of modelled WECs.

Forecasting wholesale costs and especially spot price modelling is inherently challenging and contingent on iteratively running many statistical simulations with varying parameters. There is heightened potential for greater variation between modelled and actual outcomes due to exogenous shocks (e.g. global fuel supply pressures, pandemics, floods). This was evidenced by recent events, 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).

Because of the skewed nature of wholesale electricity prices (i.e. prices can increase considerably more than they can decrease), errors in the estimation of the WEC due to contract price variation are likely to be greater when prices are increasing.[1]

The current spot price volatility has resulted in a Victorian forward curve that has doubled in value over the last year. Charts 1 and 2 below highlight the increase in ASX base future and cap prices that occurred from April 2022 across all NEM regions. This highlights the material change in market conditions since the ESC closed its contract data for the current VDO.

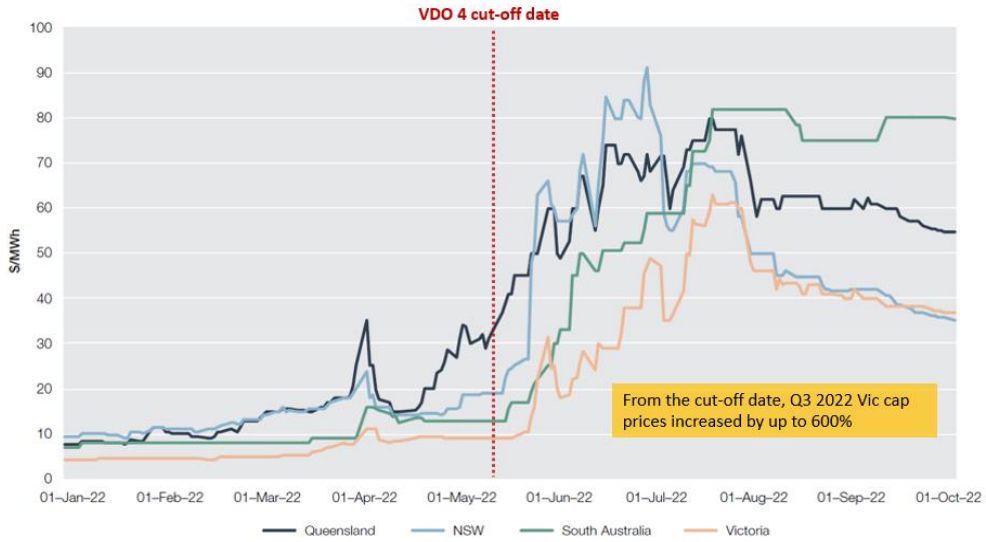
Chart 1: Q3 2022 base future prices



Source: Origin analysis of AER Wholesale Markets Quarterly (Q3 2022) data, Figure 9.1

[1] For example, see ACIL Allen, 'Default Market Offer 2022-23 – Wholesale energy and environment cost estimates for DMO 4 Final Determination', 23 May 2022, pg. 22.

Chart 2: Q3 2022 cap prices



Source: Origin analysis of AER Wholesale Markets Quarterly (Q3 2022) data, Figure 9.2

It is vital that the ESC test how well its predicative modelling captures such price volatility. In each VDO determination, the ESC should retrospectively consider whether a calculated WEC using its assumed hedging portfolio and actual load and price data would fall within its distribution of modelled outcomes.

If the actual WEC falls outside of the modelled distribution over multiple years, we believe this would demonstrate a need for the ESC to consider increasing its choice of selected percentile.

Market Intervention Costs

The period of market suspension and administered pricing in 2022 resulted in around 500 separate market interventions from the Australian Energy Market Operator (AEMO), the cost of which will need to be recovered from customers. This includes the costs associated with compensation claims made under the two different cost recovery mechanisms. It is likely these costs will be material, but the timing of when all costs will be known may occur too late for the ESC to include them in the final VDO. Should this occur, retailers could be left with significant holding costs. To mitigate this risk, the ESC should include an allowance for working capital for any market suspension costs not included in this VDO.

Retail Costs

Retail Operating Costs

We are broadly supportive of the ESC's current approach to escalate the current retail operating costs. Notwithstanding, it is also important for the ESC to recognise any changes to a retailer's regulatory obligations. New obligations can often involve significant system changes and compliance requirements for retailers, resulting in significant cost imposts. It is important that the ESC continues to recognise any new costs over above the original benchmark allowance to ensure that retailers are appropriately compensated.

Customer Acquisition and Retention Costs (CARC)

Origin supports the ESC's approach to estimate customer acquisition and retention costs.

Inflation Adjustment

The ESC has previously used the consumer price index (CPI) to escalate retail costs on the basis it is a transparent and reasonable metric. It has now suggested that because wages make up the largest share of retail operating costs and given the large increase in the CPI and smaller increase in wages, it may no longer be reasonable to use the CPI.

The issue of how to escalate retail costs has been considered previously by various regulators.

The AEMC considered the use of cost escalation in its report on best practice retail price methodology.[2] It noted that a specifically developed retail operating cost index would be the best mechanism to escalate retail operating costs, however, it would be administratively complex and expensive to develop an index that was targeted to electricity retail operating costs. The AEMC noted that while labour represents a significant portion of retailers' costs, using a wage index would not be completely reflective of the costs that a retailer incurs because the wage index does not reflect non-labour costs, and the index does not account for improvements in labour productivity. It also considered the CPI. It found that the CPI was well understood and maintains predictability and stability as well as minimising the administrative burden for the regulator. The AEMC concluded escalating retail operating costs by CPI is the best approach to use.

This issue was also considered by the QCA in it 2012-13 regulated retail decision.[3] Under its Benchmark Retail Cost Index (BRCI), the QCA had escalated retail costs from year to year using a 60/40 weighting of the change in a wage price index (WPI) and CPI. However, as part of its review, the QCA concluded that due to the difficulties of accounting for cost increases net of efficiency improvements, that it would be simpler and probably just as robust to escalate retail costs just by the CPI.

We also note that the AER uses CPI to escalate retail costs in the DMO.[4]

We acknowledge that wages do make up a reasonable proportion of a retailer's operating costs. However, this will vary from retailer to retailer. As a result, the use of a cost index will require judgement by the ESC regarding what proportion will be indexed by wages growth, whether the chosen wage index is representative of energy sector wages, and what proportion will be indexed by an alternative index such as CPI. This demonstrates that escalating costs is not a precise exercise.

Furthermore, as the ESC notes, the CPI has recently increased at a higher rate than wages. However, as diagram 3 highlights, while the two indexes are broadly correlated, there are periods when the WPI exceeds the CPI and vice versa. Notably, for most of the time since 2002, it has been the WPI that has exceeded the CPI.

Diagram 3: Wage growth versus price growth

Source: ABS Wage Price Index; Consumer Price Index

There is a temptation to depart from the CPI because it currently exceeds the WPI by a notable margin. However, as noted in diagram 3, the CPI can change rapidly. It is important that the ESC provide certainty from one year to the next. We believe over time there is no material loss of precision in adopting the transparency and simplicity of the CPI. We believe updating for actual inflation means the purchasing power of a retailer's costs are preserved. Furthermore, maintaining a method that has been applied

[2] Australian Energy Market Commission, Advice on best practice retail price methodology, Final Report, 27 September 2013, pp. 61-63.
[3] Queensland Competition Regulated Retail Electricity Prices 2012-13, Final Determination, May 2012, p.61.
[4] See AER Default Market Offer Prices 2023-24 Issues Paper, p.18; and QCA Regulated retail electricity prices for 2023-24 Interim Consultation Paper, p 12.

without contention in previous decisions and is widely accepted by energy regulators provides regulatory certainty and minimises the potential for regulatory risk.

Network costs

Unlike wholesale costs, network costs are known in that the AER approves the network prices that will be applied to retailers and customers for the forthcoming year. They are known prices that are not subject to forecast error.

For these reasons, we support the ESC's position to pass-through a retailers' network costs in the VDO and to reflect the AER's final approved tariffs in its final decision. This approach ensures retailers can recover their actual costs.

In the event this is not possible because of timing issues associated with the AER's approval of network prices, the ESC ought to use the annual network tariffs submitted by the network businesses to the AER and to apply a "true-up" in account for any differences between proposed and approved network tariffs in future years.

Environmental Costs

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

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

Yours Sincerely,

Steve Reid
General Manager, Regulatory Policy