12 August 2019

Ms Kate Symons
Commissioner and Acting Chair
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Email: RetailEnergyReview@esc.vic.gov.au

Dear Ms Symons,

RE: VICTORIAN DEFAULT OFFER ISSUES PAPER

Origin Energy appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) Victorian Default Offer to apply from 1 January 2020 Issues Paper.

As we have stated in previous submissions, we endorse a regulatory framework that supports a competitive market. This includes making it easy for customers to compare offers; allows retailer to recover their efficient costs; and sets a regulated price that fosters sustainable competition.

The ESC set a final Victorian Default Offer (VDO) for 2019 that represented around a 26 per cent reduction on the median of existing standing offer prices. As a result, initial observations are that churn is decreasing and retailer discounts are showing signs of converging around the VDO. We believe this is detrimental to the long-term health of retail competition because it demonstrates that the regulated price has been set too low and retailers are withdrawing their lowest price offers from the market.

The ESC has proposed a method for its calculation of the VDO to apply in 2020 that is broadly consistent with its current method. We maintain our views put forward in previous submissions on the calculation of parameter values. In particular, as part of the 2020 calculation, we consider that the ESC ought to devote greater consideration to how risk has been factored into the calculation of retail operating costs and the impact on competition.

In addition, as part of its 2020 determination, the ESC is also required to establish the maximum annual electricity bill for a prescribed customer on a tariff that is not a flat tariff. The ESC has indicated its preference is to establish a maximum annual bill for a range of consumption.

We do not believe it is practicable to set a benchmark maximum annual bill for non-fixed tariffs based on the annual cost for fixed tariffs because it assumes a specific consumption point when in fact the impact on consumers with different levels of consumption will be uncertain.

The ESC suggests that one option to manage this would be for retailers to simply offer both an off-peak and peak tariff that is below the VDO. Furthermore, the ESC also indicates that it would be open for a retailer to withdraw their non-flat standing offer tariffs and that there does not appear to be a strong basis for designing a more complex approach for non-flat tariffs under the standing offer framework.

However, neither option addresses the risks to retailers from the misalignment between a VDO tariff and the network tariff structure. Specifically, non-flat network charges are applied using actual usage or demand whereas under the VDO, retailers will be limited to recovering non-flat tariffs based on the maximum annual bill. As a result, if the customer has a higher energy consumption or demand during peak periods, the retailer will be liable for the difference between what it can recover under a maximum bill or flat tariff VDO and actual network charges.

We believe a regulatory framework that prevents a business from recovering incurred regulated costs (i.e. network charges) should be avoided because not only is it economically unsound, it creates unnecessary regulatory risk and perverse price signals.

For these reasons, we believe the ESC ought to ensure that its final method does not create these signals and minimises exposing retailers to financial losses.

Origin's response to specific questions raised by the ESC are set out below.

Have any major changes occurred to retail operating costs since May 2019? If so, what is the nature and magnitude of these changes?

The ESC has indicated that it will continue using the benchmark approach to estimate retail operating costs but will gather additional cost data that is consistent across all retailers.

In doing so, we urge the ESC to consult on the development of this data template to ensure that it collects data that is consistent across all retailers. As we have noted previously, the ACCC also undertook a data collection approach. However, due to limited consultation there were imperfections in the ACCC's data classification and allocation that we believe resulted in the ACCC understating operating costs.

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 ESC ought to consider an incentive-based approach like what applies to regulated networks where the regulated business is incentivised to improve efficiency over time and to share in those improvements with customers.

Are there other issues we should consider in determining retail operating margin?

The ESC has stated that the objective of the retail operating margin is to compensate the investor for the capital invested in the business and for the non-diversifiable risks associated with the investment. Compensation for discrete risks that can be quantified should be included in relevant components of the cost stack.

We do not believe that the ESC has appropriately compensated for these discrete risks. We do not believe that the ESC has sufficiently incorporated a risk allowance that provides enough flexibility to accommodate market price movements.

We have previously raised issues with respect to the calculation of an operating margin for a retail business. We retain the view that given increased market and regulatory risk, that the ESC should adopt a margin at the higher end of observed ranges

Are there any other options we should consider when determining the VDO compliant maximum annual bill that continues to meet the requirements of the order?

We recognise that the ESC has suggested that there does not appear to be a strong basis for designing a more complex approach for non-flat tariffs under the standing offer framework. Irrespective, the ESC needs to be cognisant of aligning network and retail tariffs to avoid exposing retailers to further financial losses.

We believe it is worth revisiting the reason for a TOU tariff. Network investment is largely driven by demand for electricity at peak times. A key objective of reforming tariffs is to moderate household consumption at peak times to avoid the need for unnecessary investment in network infrastructure and therefore achieve lower network prices over the long-term. The allocation of costs between peak and off-peak tariffs is also underpinned by an efficient allocation of network costs.

TOU tariffs are intended to provide customers with a signal of the network costs associated with consumption at various times during the day. Specifically, tariffs are set higher during peak periods and lower during non-peak periods in order to incentivise customers to shift consumption from peak to off-

peak periods. The imposition of a capped annual bill effectively removes the incentive for customers to shift consumption from peak periods. If overpayments are returned to customers, at the extreme this could see a customer use most of their usage during a peak period and potentially pay the equivalent of an off-peak rate.

As a result, this will distort the network price signal and create perverse retail price outcomes where customers are incentivised to access a TOU VDO and enjoy a capped peak price. Furthermore, this creates the potential outcome where a retailer's ability to fully recover their network cost liability is restricted by the legislated annual bill.

We believe this is undesirable on both counts.

One alternative could be for the ESC to consider establishing a bill benchmark split between off-peak and peak components of the annual bill. While still not optimal, it would at least allow the retailer to preserve some element of the network price signal.

While the ESC may consider that there does not appear to be a strong basis for designing a more complex approach for non-flat tariffs, creating perverse price signals will simply create an incentive for customers on cost-reflective market prices to access a regulated non-flat tariff to avoid paying charges that reflect the costs of their usage.

We encourage the ESC to develop a benchmark bill for non-flat tariffs that maintains the intent of non-flat tariff structures i.e. incentivises customers to shift consumption from peak to off-peak periods.

Closing

We consider that the ESC ought to take a conservative approach to ensure that there is an appropriate risk allowance in each cost stack that accommodates market price movements. We also believe the ESC ought to consult with retailers on the development of its proposed data template for the purposes of determining retail operating costs.

We have a number of concerns with the proposed approach to develop the annual benchmark bill for non-flat tariffs. We are concerned that the proposed approach will remove the ability for retailers to recover all the customer's network costs as well as creating broader perverse pricing incentives.

When undertaking analysis of wholesale cost, we encourage the ESC to make available the modelling that sits behind this analysis so that stakeholders have an opportunity to assess and comment on the reasonableness of the calculation and estimate of costs.

We look forward to working closely and cooperatively to support the ESC in its 2020 determination.

If you have any questions regarding this submission, please contact Sean Greenup in the first instance on

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy