12 January 2023

Adam Wilson
Chief Executive Officer
Essential Services Commission of South Australia

Submitted online: escosa@escosa.sa.gov.au

Dear Mr Wilson

INQUIRY INTO RETAIL ENERGY PRICES

Origin Energy Limited (Origin) welcomes the opportunity to provide comments on the Essential Services Commission of South Australia's (ESCOSA) Inquiry into Retail Energy Prices ('the Inquiry')

We understand the intent of the Inquiry is to investigate the performance of the South Australian electricity sector / market and associated implications for SA consumers, noting the period of unprecedented wholesale energy market volatility observed in mid-2022. Notwithstanding this specific focus, it will be important to observe market performance in the context of the broader east coast gas market over an enduring period to provide for a meaningful assessment. We also see benefit in the Inquiry leveraging information that has already been reported via other existing regulatory / monitoring processes where possible, to minimise the potential compliance burden on participants, and ensure adequate regard is given to any regulatory reforms already being progressed to improve market transparency / performance. We have provided further comments on these matters below.

1. Definition of sustained super profits

A key aspect of the inquiry is for ESCOSA to assess the potential for parties to earn (or have earned) sustained super profits. Measuring and interpreting profitability is not a straightforward exercise and there are limitations with traditional measures such as gross and net margins. As noted by the AEMC in the context of assessing the retail market, gross margins are likely to differ amongst businesses due to varying organisational structures and different customer bases, and may not give an accurate view of whether a business is economically profitable.[1] Similarly, analysis of net margins, while perhaps superior to gross margins, does not account for infrastructure costs or the risk profile of the business in question and is likely to overstate profitability.

Observed market outcomes at a particular point of time are also not necessarily indicative of profitability and the overall well-being of the market. This is particularly relevant in the context of the national electricity market (NEM), where it is well established that temporary periods of high wholesale prices are essential in enabling generators to recover fixed costs, signalling new investment and ensuring reliability of supply. A snapshot of wholesale margins at times where there is a low reserve margin and consequently higher prices would not account for the impact of periods of market oversupply and lower margins. Rather, market outcomes should be examined over an extended time horizon. This is consistent with the Australian Energy Market Commission's (AEMC) approach to analysing the potential

[1] AEMC, *2018 Retail Energy Competition Review – Final Report*, pg. 201.

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for market power in the NEM, which considered price outcomes relative to the long run marginal costs (LRMC) of generation over a sustained period.[2]

Further, NEM spot market outcomes reflect a range of different inputs, including: fuel costs; the contracting levels of market participants; system reliability requirements; and state / commonwealth renewable energy targets. Market intervention and ongoing policy uncertainty can also impede market efficiency by distorting signals for investment. It is important these factors are taken into consideration when seeking to determine whether sub-optimal outcomes are being observed in the NEM.

A holistic and transparent approach to assessing the potential for sustained super profits is therefore required that does not rely on one single metric. To this end, we consider ESCOSA should draw on the range of recent energy market monitoring reports published by the Australian Competition and Consumer Commission (ACCC), Australian Energy Regulator (AER) and Australian Energy Market Operator (AEMO) where possible to inform its overall assessment of market performance.

Having regard to the above, we observe that retail margins have continued to decline in recent years. According to the ACCC's latest analysis, in 2021-22 retail margins across the NEM were the lowest on record, decreasing by 33 per cent and 50 per cent respectively (in real terms) for residential and small business customers, relative to the previous financial year.[3] Coincident with this, the recent uplift in wholesale energy costs and volatility has had a commensurate impact on the risks faced by retailers. Retailers now face elevated risks relating to:[4]

- higher working capital requirements (e.g. due to increased hedging and prudential costs);
- increased volume and shape risk, (e.g. due to customer load varying relative to what has been forecast (and therefore hedged), both in terms of the level and time of usage); and
- rising debt risk, with expected non-repayment of customer debts set to increase in the current environment.

The recent unprecedented period of wholesale energy market volatility was driven by a combination of underlying factors. As noted by AEMO, reduced availability of coal-fired generation (due to outages and coal supply constraints), drove higher demand for gas-fired generation, which both raised electricity prices and put pressure on local gas markets.[5] This occurred at a time when broader geopolitical issues were already putting upward pressure on fuel prices and the onset of cooler weather was driving increased demand for gas.

2. Assessing the impact of vertical integration and financial trading arrangements

The terms of reference require ESCOSA to have regard to the impact of vertical integration and financial trading arrangements as part of its assessment of profitability. Issues that should be considered by ESCOSA in assessing these factors are noted below.

- *Vertical integration*: The extent of effective integration should not be determined by simply observing an integrated entity's generation and load. There is generally a significant mismatch between the location and profile of the generation and retail loads of each vertically integrated retailer across the NEM. As a result, integrated firms are still active participants in hedge markets.

[2] AEMC, *Potential Generator Market Power in the NEM – Final Rule Determination*, 26 April 2013, pg. iii.
[3] Ibid, p. 72-73.
[4] See Origin's submission to the AER's *Default Market Offer Prices 2023-24 Issues Paper* for further discussion around retailer costs / risks: https://www.aer.gov.au/system/files/Origin%20Energy%20-%20AER%20DMO%205%20Issues%20Paper%20-%205%20December%202022.pdf
[5] AEMO, *Quarterly Energy Dynamics Q2 2022*, p. 3.

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and also have a strong incentive to supply hedge contracts, even in preference to using generation to back their retail load if hedge prices diverge from expected spot prices.

Further, the benefits of vertical integration should not be discounted. Vertically integrated entities have made significant investments in generation capacity across the NEM. This is because vertical integration represents a proven and prudent strategy to managing exposure of retail load to wholesale spot prices in an energy only market. By enabling improved risk management, the realisation of economies of scale and potentially providing access to credit on more favourable terms, vertical integration can also assist in lowering costs and ultimately prices in the long term when compared to a counterfactual where there is no integration.

- *Financial trading arrangements*: South Australia has historically observed a lower level of contract market liquidity relative to other NEM regions. In Origin's view, this is largely a function of SA's unique generation mix:

  - Over 60 per cent of the energy generated in SA comes from wind and solar generation.[6] The characteristics of these technologies mean they have not traditionally been providers of hedge contracts.

  - Relative to other NEM regions SA lacks baseload generation, with the AER recently noting the closure of baseload generation reduces the amount of contracts on offer.[7]

  Given the above, it is important to recognise that participants utilise a range of other products to manage risk, including weather derivatives, power purchase agreements (PPAs), over the counter (OTC) contracts, structured hedge contracts and inter-regional hedging. Any analysis of financial trading arrangements (including liquidity) should have regard to the impact / role of this broader suit of products / tools.

3. Minimising duplication and regulatory burden

Origin observes the continuing extensive regulation and monitoring of energy markets, including the ACCC's continuing inquiry into the prices, profits and margins in the supply of electricity in the NEM. In collecting participant data for the Inquiry, Origin encourages ESCOSA to minimise the potential compliance burden on participants and avoid duplication by leveraging reporting / analysis that has already been undertaken through other existing regulatory / monitoring processes (e.g. AEMO / AER monitoring reports, and the ACCC's ongoing inquiries into electricity and gas markets). In the event additional participant information requests are required to inform the Inquiry, Origin encourages ESCOSA to consult with participants prior to issuing requests and sees value in ESCOSA drawing on the approach of other regulators in terms of the content and structure of requests and timeframes for compliance.

When formulating any recommendations around the potential need for reform, it will also be important for the Inquiry to be mindful of any implications for the broader national market and the impact of reforms that are already in train. To this end, we note several reforms are being progressed that are intended to improve the transparency and performance of wholesale energy and contract markets, including: Gas Transparency Measures[8], expansion of the AER's wholesale market monitoring functions[9], reforms to

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[6] AEMO, Data Dashboard, accessed: https://aemo.com.au/Energy-systems/Electricity/National-Electricity-Market-NEM/Data-NEM/Data-Dashboard-NEM,14 December 2022.
[7] AER, *Wholesale Electricity Market Performance Report – December 2022*, p. 47.
[8] For more detail refer: https://www.energy.gov.au/government-priorities/energy-ministers/energy-ministers-publications/regulatory-amendments-increase-transparency-gas-market
[9] For more detail refer: https://www.energy.gov.au/government-priorities/energy-ministers/energy-ministers-publications/amending-australian-energy-regulator-wholesale-market-monitoring-and-reporting-framework-consultation-paper

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pipeline regulation[10] and more frequent ACCC reporting on the gas market. These reforms should be given time to take effect.

If you wish to discuss any aspect of this submission further, please contact Thomas Lozanov at thomas.lozanov@originenergy.com.au.

Yours Sincerely,

S Cole

Shaun Cole
Group Manager, Regulatory Policy

[10] For more detail refer: https://www.energy.gov.au/government-priorities/energy-ministers/energy-ministers-publications/energy-ministers-agree-final-package-gas-pipeline-regulatory-amendments