Essential Services Commission
Level 8, 570 Bourke Street
Melbourne Victoria 3000

Submitted online.

11 April 2023

RE: Victorian Default Offer 2023-24 Draft Decision

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the Essential Services Commission's (ESC) *Victorian Default Offer 2023-24 Draft Decision Paper* (the **'Draft Decision'**).

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations and will focus on matters relating to the Draft Decision. It does not consider the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised in their own submissions.

With unprecedented high and volatile wholesale prices over the past 12 months, the AEC's submission to the ESC's Victorian Default Offer 2023-24 Consultation Paper in January 2023 cautioned that the challenge for the ESC (and other price cap regulators) is to avoid overreach and reactivity, and ensure any determination is sensitive to retailer viability.

Overall, the AEC commends the ESC for the stable and principle-based approach applied in its Draft Decision. While there will be varied views regarding price setting methodologies (and there are many), during times of high volatility and increased risk for market participants, it is most critical that regulators prioritise consistency so retailers can optimise their processes and procedures to allow them to recover their efficient costs. Noting that, the AEC strongly agrees with the ESC's comment, that: *"Allowing retailers to recover efficient costs will help avoid costly retailer of last resort events, such as those that affected the United Kingdom in financial year 2021-22. It will also ensure that retailers continue to invest in the industry to drive the types of innovation that lead to long-term sustainable cost-efficiencies."*[1]

The AEC recognises that to achieve trust across stakeholders, the ESC, when determining a reasonably priced VDO, must balance the need for simple and transparent calculation methods with the goal of delivering, as close to practicable, a price that fairly represents a prudent and efficient retailer. In doing so, the ESC, necessarily, applies materiality assessments and points of compromise.

Given the disruptive features of the energy transition, these points of compromise need to be regularly reassessed to ensure the VDO continues to meet its objectives. In the following submission, the AEC

[1] Essential Services Commission, Victorian Default Offer 2023-24, Draft Decision Paper, March 2023, p5.

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sets out specific points of response to the Draft Decision and highlights where such points of compromise warrant attention.

Wholesale energy costs

The AEC supports the ESC's approach to determining the wholesale energy cost (WEC) for the Draft Decision. One of the most valuable contributions retailers make in the electricity supply chain is to manage wholesale price volatility for and on behalf of their customers. In a regulated price environment, system stability can only be maintained if retailers can recoup the cost of undertaking this vital function. To this end a consistent approach is key, in effect acting as a tacit regulatory 'contract' between retailer and regulator – giving retailers confidence that if they act in accordance with the approach of the regulator, they will not be unreasonably disadvantaged at the time of decision.

The approach adopted by the ESC in prior years has signalled to retailers to build up their hedge cover over the twelve months prior to the determination year. That is, in forecasting their revenue and building up their hedging portfolios, retailers have acted on the basis that the 2023-24 VDO will reflect futures traded during 2022-23. This signal is particularly important during a period of high prices, where a retailer might opt to act differently in circumstances absent such an understood approach.

The AEC therefore supports the application of trade weighted average price of contracts from all days over the past twelve months (excluding options). The AEC notes that, assuming prices of futures traded in the current year remain less extreme and less volatile than the prior year, this consistent approach should deliver a lower price for VDO customers in 2024-25. By contrast, in such a scenario, the method employed in the Australian Energy Regulator's Default Market Offer (DMO), involving price observations across multiple years, should result in higher price rises in the 2024-25 DMO when compared with the VDO for that year.

In addition, the AEC encourages the ESC to monitor (for potential future material impacts) the following factors for consideration in the 2024-25 determination and beyond:

- **(i)** **Impacts on settled load shape of unaccounted for energy (UFE):** As a body of trending data has become available since the implementation of global settlements, impacts of the 'true' NSLP shape on retailer hedging costs (up or down by network zone) may become apparent.
- **(ii)** **Volume-weighted impact of over-the-counter futures contracts on WEC prices**: The AEC acknowledges that the ESC is already monitoring this factor for materiality.
- **(iii)** **Allowance for extreme market movements:** The AEC supports and acknowledges the ESC inclusion of a volatility allowance designed to compensate prudent retailers for the costs of holding sufficient working capital to remain financially viable through periods of peak demand and price. The AEC, however, notes that the current VDO methodology does not allow for working capital support for the type of extreme market scenario where, over an extended period of time, demand sits above the swap covered position simultaneous to prices landing above the WEC allowance. In such scenarios retailers incur negative margin over time. The AEC recommends the ESC monitor the prevalence of such scenarios and considers the cumulative negative margins retailers take on in such events.

Retail operating costs

The AEC supports the ESC's periodic reassessment of all pricing elements including the allowance for retail operating costs (ROC). While the AEC also supports the use of actual data collated from the Victorian retailers for regulatory price assessments, sudden material revisions should be applied in a glidepath manner and/or specifically consider, recent historical cost-allowance gaps for items such as the cost of Consumer Data Right (CDR) implementation. A longer lead time for these pricing revisions would mirror the lead time for retailer cost reduction initiatives.

The AEC encourages the ESC to monitor (for potential future material impacts) the following factors for consideration in the 2024-25 determination and beyond:

(i) **Bundling of allowance for bad debts:** Bad debt expenditure is a function of the risk of customer default and the size of customer bills - in essence, a variable cost proportionate to retailer income. Bundling bad debt recoveries in with other ROC elements (which are logically applied as a cost per customer) imposes a cross subsidy whereby small customers are at risk of being overcharged to the benefit of larger consumers. As overall bill sizes increase, the AEC encourages the ESC to monitor the size of such cross-subsidy impacts and, if material, consider separating bad debts from ROC and then apply a percentage of income method to determine the bad debts element.

(ii) **Weighting of retailer ROC data:** It is important that any regulated price still promotes industry competition and innovation. To this end, the AEC encourages the ESC to continue to monitor the gap between the ROC determined under the current customer weighted approach and the ROC reasonably expected for a start-up and prudent Tier 2 retailer.

Consultation papers

The AEC supports the ESC's proposed process including the 'request for comment' notice at the start of future reviews. Given the dynamic nature of the sector at this time, such forward planned and public consultation is important and the AEC looks forward to continuing to participate in such processes.

Further recommendation

As mentioned above, in the AEC's view, the financial viability of retailers is key to a stable electricity supply chain. In a regulated price environment such viability is best supported through a forward-planned, transparent, and consistent approach. Therefore, the AEC recommends the ESC develop a forward plan for the reassessment of each pricing element including a minimum frequency commitment into the future.

Any questions about this submission should be addressed to Jane Sing – Interim Retail Policy Lead, by email to Jane.Sing@energycouncil.com.au or by telephone on (03) 9205 3100.

Yours sincerely,

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