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Re: Next steps for the Victorian Default Offer: Consultation on our approach to network tariff reforms and determination process

AGL would like to further respond to the *Next steps for the Victorian Default Offer – consultation on our approach to network tariff reforms and determination process* (Consultation paper) released by the Essential Service Commission (ESC) on the 14 May 2021.

AGL has previously submitted its agreement with the ESC's proposed approach to varying the 2021 Victorian Default Offer (VDO) and would now highlight its initial views on the methodology for the 2022 VDO.

The ESC has indicated that it will largely use the same approach that it has used previously to determine the VDO prices and is specifically seeking views on the approach to bad debts and the length of the regulatory period to apply from 1 January 2022.

Firstly, AGL would contend that:

- the length of the 2022 VDO regulatory period should be set at six months; and
- at a minimum, the adjustment for bad debts currently allowed in the 2021 VDO needs to be extended for the 6 months of the 2022 VDO.

AGL's reasoning is detailed below.

Secondly, although AGL is generally supportive of the ESC following its current methodology for the 2022 VDO, it would highlight that the 6-month regulatory period (or indeed an 18-month regulatory period) will require some adjustments to the method normally used to calculate the wholesale energy cost.

The current method forecasts an annual cost that, in effect, averages the wholesale energy costs over the four quarters of a calendar year (Q1 to Q4). These quarterly costs are very different, especially over the summer period (Q1). Simply using an annual forecast for wholesale energy cost in the VDO 2022 would therefore underestimate a retailer's cost over that six-month regulatory period.

AGL has suggested some alternative methods that the ESC could consider in order to account for this issue in the 2022 VDO.

Length of regulatory period

AGL strongly supports the next regulatory period being 6 months, starting from 1 January 2022.

From 1 July 2021, network tariffs will change to a financial year basis and AGL strongly agrees with the ESC's preference to align the VDO regulatory periods and Victorian network businesses' regulatory periods as soon as practical.

The earliest date for this alignment is 1 July 2022 which therefore requires a six-month regulatory period for the 2022 VDO.

The alternative, an 18-month regulatory period, creates the significant risk of the VDO diverging from efficient costs but provides no added benefit as it will still require VDO prices to change on 1 July 2022 to account for network price changes.

Bad debts due to COVID-19

In AGL's 2020-21 Half-Year Results presentation (released on 11 February 2021), we reported that the incremental credit loss due to COVID-19 for the full year was forecast at $35 million, noting that significant uncertainty still existed. While this forecast was slightly better than an earlier forecast, with AGL reducing the provision by $5 million, this represented a material increase in expected credit loss over the previous year. Total expected credit loss for 2020-21 is expected to exceed the provisions for losses in recent years.

In the final decision in relation to the VDO from 1 January 2021, the ESC included an adjustment for increased bad debts due to COVID-19 of $6 per customer. The ESC highlighted in its Consultation Paper that retailers' information shows the average arrears for customers continues to increase.

We also note that more recently, in April 2021, the AER in their final determination of the Default Market Offer (DMO) price for 2021-22 estimated the increase in the provisions for bad and doubtful debt due to COVID-19 of $9 per customer for 2021-22. Given the greater impact of COVID-19 in Victoria compared with other Australian states, it is reasonable to expect that the additional allowance for bad debts under the VDO should be much higher than for the states covered by the DMO framework.

With respect to 2021-22, while the overall impact of COVID-19 has been more moderate than expected, there is still uncertainty as to whether credit losses will return to pre-COVID-19 levels, particularly in Victoria.

AGL believes the allowance for bad debt expenses due to the coronavirus pandemic should be retained in the 2022 VDO, noting that if it is a six-month regulatory period, this will mitigate much of the risk of forecasting uncertainty with regard to retailers' total bad debts for 2022.

Wholesale Electricity Cost (WEC)

The pricing of retail electricity contracts lends itself to annual price changes because it:

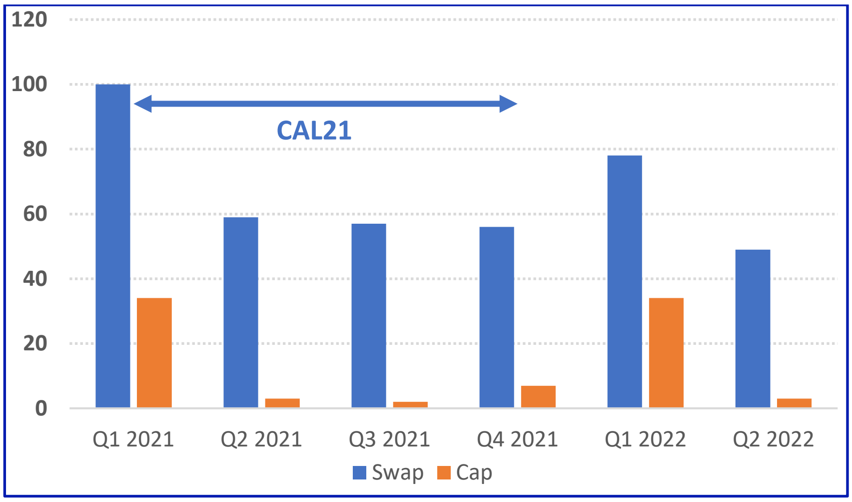
- aligns with annual network price resets;
- aligns with other regulatory cost changes, such as the changing annual targets for environmental schemes; and
- allows the estimation of an annual wholesale energy cost that covers a retailer's forecast load for the upcoming year and accounts for the seasonality of the wholesale market.

AGL use this annual approach for its existing customer contract base, largely consistent with the methodology used to calculate the VDO.

Forecasting a wholesale energy cost for a shortened period is problematic due to the variation in contract prices and customer load over the four quarters of a year.

Figure 1 highlights the variation in Victorian contract prices (caps and swaps) for the four quarters of 2021 and for the first 2 quarters of 2022. These contract prices are the major factor in determining a wholesale energy cost using a market-based methodology, as applied by Frontier Economics in the VDO determinations. These contract price variations, especially the price of caps in Q1 of each year, are significant and produce very different wholesale cost estimates, that are smoothed out when establishing a single annual cost for the year.

Figure 1: Victorian Swap and Cap prices for Q1 2021 to Q2 2022*



*Time weighted average over the 24 months to 15 October 2020 (for CY21) and 1 April 2021 (for H1 CY22)

It is therefore inappropriate to use an annual forecast for wholesale energy cost to calculate the 2022 VDO as it will underestimate the cost to retailers over that period if no adjustments are made.

AGL has identified two alternatives for the ESC's consideration that would resolve this issue.

1. The obvious option is that the ESC estimates a wholesale energy cost that reflects the cost of the first two quarters of 2022, using the relevant contract prices and load shape. Although obvious, it is not straight-forward and AGL is aware of the likely difficulties for Frontier Economics in estimating a wholesale energy cost for the 6-month regulatory period. It also may require some consideration of the smoothing of the cost into the next VDO period if contract prices for Q1 in 2022 were to increase substantially.

2. The other alternative is that the ESC uses its current methodology to estimate a single annual wholesale cost and use this estimate in the 2022 VDO. This will underestimate a retailer's cost for the first 6 months of 2022 and normally, this cost would be recovered in quarters 3 and 4. However, a new VDO and wholesale cost will be set on a financial year basis from 1 July 2022 which will preclude this recovery.

   However, the ESC can ensure retailers are recompensed by making the necessary adjustment to the wholesale energy cost used in its 2022-23 VDO.

   Simply put, the under-recovery could be calculated as the difference between the estimated wholesale energy costs for the calendar and financial years when they overlap in Quarters 3 and 4 of 2022. This difference can then be spread across the entire 12-month period for the 2022-23 VDO so that it has minimal effect on customers and the wholesale energy cost is consistent throughout the year.

[redacted]

Yours sincerely

Elizabeth Molyneux
GM of Policy and Market Regulation