EnergyAustralia
LIGHT THE WAY

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EnergyAustralia Pty Ltd
ABN 99 086 014 968

Level 19
Two Melbourne Quarter
697 Collins Street
Docklands Victoria 3008

Phone +61 3 8628 1000
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au
energyaustralia.com.au

Chairperson Kate Symons
Commissioner Sitesh Bhojani
Commissioner Rebecca Billings
Commissioner Simon Corden
Level 8
570 Bourke Street
MELBOURNE VIC 3000

Lodged electronically: www.engage.vic.gov.au

Dear Chairperson and Commissioners,

2022 VDO review – Supplementary submission – Public version

EnergyAustralia is one of Australia's largest energy companies with around 2.3 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise 4,500MW of generation capacity.

EnergyAustralia makes this supplementary submission following its first submission to the 2022 VDO review.[1] We consider it beneficial to expand on one issue in our previous submission and raise two new issues before the Commission makes its Draft determination. This will allow the Commission to further develop its Draft determination as it relates to these issues and allow further industry comment in the second round of consultation.

Wholesale electricity costs for six-month regulatory period

As per our previous submission, our main concern still relates to calculating wholesale electricity costs for a six-month VDO and the need to ensure the appropriate recovery of the higher Q1 wholesale electricity costs.

This issue arises because the current VDO methodology effectively averages the wholesale electricity costs over the four quarters of a calendar year. These costs are different across the quarters due to seasonality, with Q1 costs being significantly higher. Adopting a 12-month wholesale electricity cost average for a VDO that only covers six months (H1 2022) (and the six months with the higher Q1 costs) would result in an under-recovery of those higher Q1 costs. This issue is not resolved in the subsequent regulatory period for financial year 2022-2023 as that forms part of a separate 12-month period. Several other Retailers also raised this issue in response to the Consultation Paper.

[1] https://www.esc.vic.gov.au/sites/default/files/documents/SS%20-%20EnergyAustralia%20-%202022%20VDO%20submission%20to%20CNP%20-%2020210616%20PUBLIC.pdf

We are concerned that an under-estimate of wholesale electricity costs could fail to ensure that the VDO is based on the efficient costs of the sale of electricity by a Retailer, as required under the relevant Order in Council.[2] We consider if the ESC were to adopt a 12-month wholesale electricity cost approach for H1 2022, there would be a risk of an under-estimation of efficient wholesale electricity costs for the H1 2022 period.

This under-estimation would result in an under-recovery which could affect Retailer viability. As the Commission is aware, the VDO effectively constrains what a Retailer can charge Standing Offer customers. The impact of any under-recovery could be greater for Retailers depending on the hedging profile adopted by the Retailer, i.e. Retailers with a shorter hedge or more exposure to spot electricity prices would be more affected.

When making a VDO determination, the ESC must adopt an approach and methodology that is in accordance section 33(2) of the *Essential Services Commission Act 2001* (*ESC Act*). Section 33(2) requires that the Commission must adopt an approach and methodology which best meets the below objectives (as well as the objective of the VDO):

- Objectives of the *ESC Act* – to promote the long-term interests of Victorian consumers, which in turn requires the Commission to have regard to the financial viability of the industry, and
- Objectives of any relevant legislation, namely the *Electricity Industry Act 2000 Vic* which includes the objective to promote the development of full retail competition.

The Commission should investigate the effect of an under-recovery associated with a 12-month wholesale electricity cost approach on Retailer viability, with a comparison to Retailer margin data submitted to the Commission. [Confidential

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This under-recovery issue applies to the current determination of the 2022 VDO which is independent of previous Commission determinations. However, EnergyAustralia recognises that the Commission faced the same issue when it set the first VDO which had a six-month regulatory period, but that the difference was that period was a second half year (H2 2019). At that time the Commission used a 12-month wholesale electricity cost approach which could have resulted in an over-recovery of wholesale electricity costs. We recognise that the Commission may prefer to adopt a consistent regulatory approach. Ultimately however the Commission needs to consider the requirements of the Order in Council and legislation. For completeness, we discuss the Commission's previous reasons for its H2 2019 approach below.

The Commission's 2019 Draft Report provided the most detailed discussion on policy intent around its previous approach:

> To determine the level of future prices, the commission has used contract prices published by ASXEnergy for each quarter from 1 July 2019 to 30 June 2020. Although our recommendation is for the first VDO to apply until 31 December 2019, *we do not*

[2] Clause 12(3), Victorian Government Gazette, No. S 208 Thursday 30 May 2019

think it is reasonable to estimate wholesale purchase costs for a six-month period, as this is unlikely to reflect the approach taken by Retailers to supplying their customers. That is, Retailers would generally set prices expecting to serve the customer for longer than a six-month period. It would also significantly understate the cost incurred (by excluding the first quarter of 2020), which could affect the financial viability of the industry and mean that there may be a large increase to the VDO applying from 1 January 2020.[3]

The Commission's reasons appear to be three-fold:

1. Retailers would generally set prices expecting to serve customers for longer than a six-month period.
2. The risk of significantly understating the cost incurred (by excluding Q1 2020 costs) which could affect the financial viability of the industry.
3. If the Commission were to take a six-month view of wholesale electricity costs, there may be a large increase to the next VDO. i.e. the Commission sought a smoother price path.

Addressing these reasons in the 2022 VDO context:

1. We agree that Retailers usually set prices over a longer period than six months, even when it was not required by the *Energy Retail Code* (Vic). Retailers may avoid changing prices more than once a year for any customer because they are likely to manage price risks over a longer period and frequent price changes can result in poor customer experience.

   However, the current circumstances are unique and should be considered as an exception. In parallel with the ESC moving to a financial year VDO to align with network tariffs, Retailers may also be adjusting their own pricing practices from calendar year to financial year. In our experience, pricing decisions are not made in isolation of VDO determinations. If the VDO is set on a 6-month basis then it is reasonable for Retailers to align Market Offer tariffs with that shorter time frame. These unique circumstances should be considered.
2. The Commission previously referred to understating the wholesale electricity cost incurred, if H1 2020 was not included in the costs for the first VDO. We agree with the Commission's overall reasoning – that understating the wholesale electricity cost incurred could affect the financial viability of the industry. The same issue is arguably more material for the H1 2022 VDO, as discussed above.
3. We understand the concern around price smoothing but consider that a solution could be designed to smooth the price path, if a 6-month approach for wholesale electricity costs resulted in a significantly higher VDO for H1 2022. These costs could be spread over two VDO regulatory periods (18 months).

Section 46AA of the *Energy Retail Code*

We ask that the ESC exercise its discretion to not enforce section 46AA of the ERC in the event a Retailer needs, in order to recover its efficient costs, to increase its Market Offer tariffs after the next VDO takes effect on 1 January 2022 (given this would be outside the *Network tariff change date*).

This is a one-off request which reflects the unique circumstances of transitioning to the financial year regulatory period for the VDO and the additional VDO price determination on 1 January 2022.

We submit that this exercise of discretion is appropriate for the following reasons.

Similar to the ESC undertaking multiple steps to align the VDO price from a calendar year to financial year regulatory period, Retailers should be allowed the opportunity to align or link existing Market

[3] Draft advice - Victorian Default Offer to apply from 1 July 2019 (for web publishing) (1).pdf, p 23

Offer tariffs to the VDO at each point the VDO changes. Retailers are accountable for demonstrating to customers if their price movements differ to the VDO as the VDO is a clear and public benchmark. Aligning the nature and timing of Market Offer tariff changes with VDO price changes is also the most efficient outcome from a regulatory perspective. It supports the effectiveness of the VDO as a benchmark of the "efficient price" against which all Market Offers are compared.

[Confidential:

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Significant increases to Victorian Energy Upgrades (VEU) costs

We note that market prices for VEU certificates have doubled in the last six months and that the magnitude of this increase may warrant a temporary adjustment to how VEU costs are accounted for in the VDO to bring forward these increases.

The current 2021 VDO reflects an average price of $32.38 per certificate for 2021. The current market price is around $65. This difference equates to about [Confidential:]. Our internal estimates below show that this increasing price trend for VEU costs will continue but at a slower rate.

[Confidential:

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We ask that the Commission provide an advance upwards adjustment in the VDO to reflect the materially higher VEU costs for 2021. This can be adjusted via a later true up in a subsequent VDO to reflect actual historical VEU costs for the 2021 period as they become available.

If you have any questions in relation to this submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761)

Selena Liu
Regulatory Affairs Lead