8 October 2021

Ms Kate Symons
Chair
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne Victoria 3000

Email: VDO@esc.vic.gov.au

Dear Ms Symons

RE: 2022 Victorian Default Offer – Draft Decision

Origin Energy (Origin) appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) draft decision for the Victorian Default Offer (VDO) to apply in 2022.

The COVID pandemic has now extended to over 18 months and we fully expect it will continue to have a corrosive impact on the economy for the foreseeable future. We continue to be faced with random lockdowns which disrupt the everyday lives of our customers. We are seeing the impacts manifest in growing customer debt and increased pressure on retailer operations.

As a result, it is vitally important that the ESC strike a balance between delivering regulatory certainty with pragmatic and flexible decision making that recognises the unique challenges of a pandemic. In particular, the ESC faces significant challenges with respect to how to treat costs associate with COVID-related debt and the Victorian Energy Upgrades (VEU) program.

The ESC has noted that retailers have lowered their expected doubtful debt expenses in their latest annual financial statements, and they have not forecast the risks of COVID repeating in 2022. However, Origin made its judgement using the best available information at that time of our Annual Results. Since then, we have seen a more contagious variant (Delta) emerge which has resulted in further hard lockdowns and stay at home orders in Victoria which commenced on 2 August 2021 and may not end until late October 2021. As a consequence, the ESC has published standing advice expecting retailers not to disconnect a residential customer who is isolating or quarantining during the current lockdown. Victoria recently passed more than 250 days of lockdown since the pandemic commenced, during which disconnection has been tightly managed and restricted by the ESC.

These conditions increase the likelihood that customer debt will increase beyond what we had originally anticipated. However, adopting a one-dimensional approach such as relying on financial statements limits the extent to which COVID-related debt costs can be estimated for regulatory decisions, and for the ESC to design measures to minimise retailers' exposure. We request that the ESC look beyond what was reported in the annual financial statements and examine the relationship between key debt measures and potential future changes in bad and doubtful debt.

Another significant challenge for the ESC is how to assess VEU costs. As a result of COVID, the number of installations and therefore certificates being generated have dropped significantly. This supply side constraint has increased the risk of retailers not being able to acquire and surrender sufficient certificates. As a result, retailers are facing paying the penalty cap; which is not included in the ESC calculation of VEU costs for the VDO. This shortfall in certificates is expected to amplify in response to the Victorian Government's decision to remove lighting from the scheme. These issues were never anticipated when the ESC determined its approach to cost recovery, and we feel the ESC's method no longer reflects the physical operation of the scheme. For this reason, we strongly urge the ESC to consider how it can best compensate retailers for this increased risk that has resulted outside of their control.

Origin's views on these issues and other elements of the ESC's draft decision are set out below.

COVID-Related Debt

As part of the 2021 VDO, the ESC made an upward adjustment of $6 to the retail cost benchmark to reflect the expected effect of COVID on retailers' bad debt costs.

The ESC calculated the $6 allowance based on the simple average of the per customer cost of bad and doubtful debt because of the pandemic as reported by retailers in their 2020 public financial statements. Origin's Annual Report 2020 identified bad and doubtful debts of $113 million for FY2020, including a bad and doubtful debt provision relating to COVID risks of $38 million. This equated to a COVID-19-related bad and doubtful debt provision of $9.50 per customer.[1]

The ESC notes in its current draft that, based on the most recent public financial statements released by retailers, bad and doubtful debt expenses have broadly returned to pre-COVID levels.

We agree that at face value the data reported in retailers' financial statements supports the view that COVID risks were expected to dissipate. That was a judgment Origin made at the time based on all the information available to us. However, since then, we have seen a more contagious variant (Delta) emerge which has resulted in further hard lockdowns and stay at home orders. This has resulted in a return to the financial pressures that both customers and retailers were experiencing in late 2020 and early 2021.

COVID risks are not static, and the consequences move at pace. Adopting a one-dimensional approach such as relying on financial statements limits the extent to which COVID-related debt costs can be estimated for regulatory decisions, and for measures to be designed to minimise retailers' exposure.

With this in mind, the challenge for the ESC is to make a judgment, not just based on retailers' financial statements but to take a more forward-looking approach. We believe that 90 plus day debt provides an insight into the future movements of bad debt. In particular, 90 plus day debt levels and the number of customers with 90 plus day debt.

[redacted]

[redacted]

[redacted]

[redacted]

[redacted]

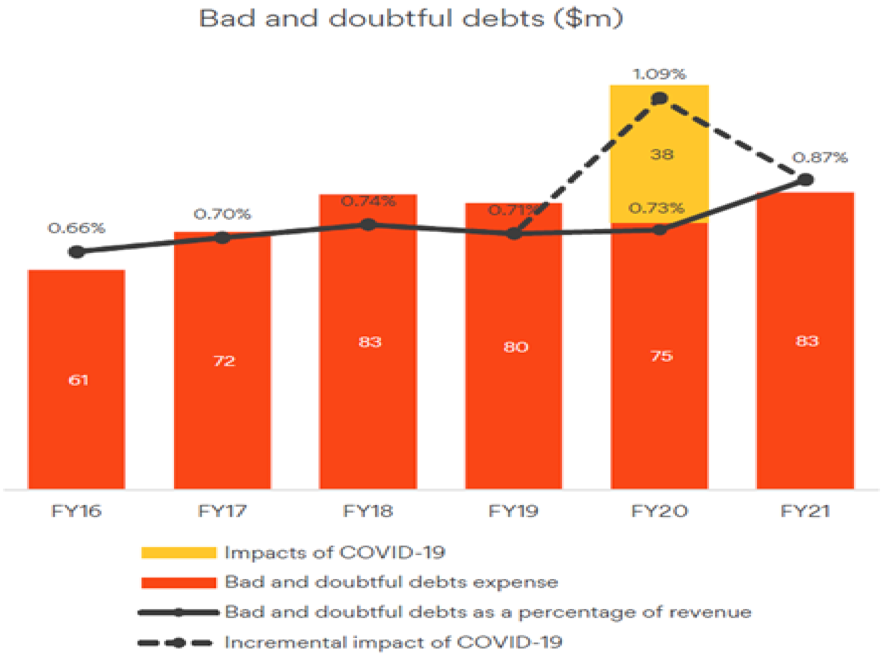
[1] AGL estimated an increase in bad debts of approximately $5 per customer and Red/Lumo Energy provided an estimate of approximately $4 per customer.

[2] See https://www.esc.vic.gov.au/sites/default/files/documents/Energy%20customers%20during%20COVID%20-%20up%20to%2029%20August%202021%20%28public%29.pdf

[redacted]

The impact of this debt as a proportion of revenue is shown in diagram 3. As this shows, while bad debt levels have moderated, they remain high as a proportion of revenue when compared to pre-COVID levels.

Diagram 3: Bad Debt as a Proportion of Revenue



[redacted]

Economic indicators

We also note that the extent and pace of the economic recovery remains uncertain. For example, the most recent OECD Economic Survey for Australia (September 2021) indicates that the current strict lockdowns in NSW and Victoria will result in GDP declining in the third quarter of 2021 and a more gradual recovery than previously forecast by the OECD (in May 2021).[3] This has implications for residential and small business customers and consequently retailers' bad debt costs.

While Victoria's hard lockdown is expected to ease in the coming month(s), there remains considerable uncertainty regarding the pace and extent of recovery and indeed whether future lockdowns may again

[3] OECD (2021), OECD Economic Surveys: Australia 2021, OECD Publishing, Paris.

be required. [redacted] Given this uncertainty, we consider it pragmatic for the ESC to err on the side of caution when considering the merits of extending an allowance for COVID-related debts in the 2022 VDO. With the shortened six-month regulatory period, the cost of any regulatory risk is likely to be higher by not allowing some form of allowance for COVID-related debt.

Victorian Energy Upgrades program

The VEU program requires retailers to surrender Victorian Energy Efficiency Certificates (VEECs) to meet Government efficiency targets, acquiring these certificates from accredited service providers following the installation of activities or from the market. Where retailers do not surrender sufficient certificates, they are required to pay a penalty cap price on the shortfall.

The ESC calculates the allowance for VEU costs using a 12-month weighted average price. As a result, in some years the allowance in the VDO will be higher than the actual market price and lower in other years. To date, this approach has been fine because over time a retailer's exposure nets to zero.

However, the VEU scheme is currently experiencing unforeseen supply side disruption which we do not see correcting. These issues were not anticipated when the ESC developed its cost-recovery method and as a result retailers will be exposed to significant financial losses unless the ESC modifies its approach.

The supply-side issues are twofold: 1) COVID-related; and 2) scheme related.

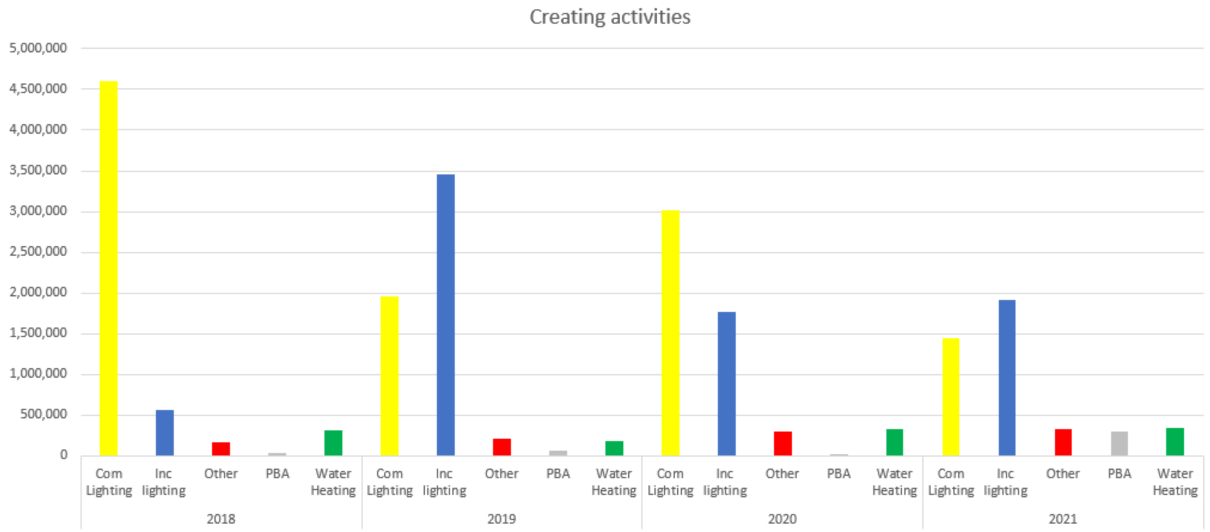
Firstly, because of the COVID lockdowns, installers have been unable to perform work and lead generation business were unable to quote future work. The impact has seen certificate creations drop dramatically in the second half of 2020, leading to liquidity issues in both the spot and forward market. With lockdowns continuing we expect this trend to continue.

Secondly, at the same time the Victorian Government has announced a reduction in incentives for lighting activities. Specifically, effective 1 August 2021, there was an immediate 35 per cent reduction in incentives for all works carried out under this activity. A further reduction in the emission factor multiplier of 0.2 also applies. In effect, the overall reduction is ~50 per cent. From 1 March 2022, this activity will cease altogether, and no incentives applied.

With respect to commercial lighting, effective 1 April 2021, the emissions reduction factor was reduced from 0.8 to 0.6. This activity has not been phased out completely but has an implied reduction in incentive of 40 per cent.

To highlight the significance of lighting, diagram 4 below shows the contribution of different activities to VEEC creation.

Diagram 4: VEEC Creation Activities



The removal of lighting will further constrain the generation of certificates and continue to erode the liquidity of the market; there are simply not enough certificates being created.

As a consequence of these supply side issues, the VEEC price has rallied from its lows of $18 in 2019 to $83 in the current spot market (+450% increase) (see Diagram 5 below).

Diagram 5: VEEC Spot Price

We do not see these supply issues dissipating. As at early September 2021, only 1.2m VEECs have been created across the market that contribute towards the Cal 22 target of 6.7m (18%). We expect these issues to persist.

As a result, retailers are facing the real prospect of installers defaulting on their contracts meaning they will have insufficient certificates to meet their obligations. To address this, retailers can either purchase the shortfall from the market or pay the penalty cap. Given the illiquid market, it may not be possible to acquire sufficient certificates therefore retailers will have a greater exposure to the penalty cap than they otherwise would have.

The problem is that the ESC's allowance methodology does not include retailer exposure to the penalty cap price, only the market price. For the VDO draft decision, the ESC proposes a certificate price of $49 based on a 12-month weighted average certificate price, noting that the price will be updated in the final decision with the most recent data available.

Retailers are exposed to both the shortfall in certificate prices and an increase in penalty payments (many of which are due to unfulfilled contracts and beyond retailers' control). While the ESC's proposal to adopt a weighted average approach addresses the movements in the certificate price over time, there is no provision for retailers being exposed to penalty payments because of a certificate shortage.

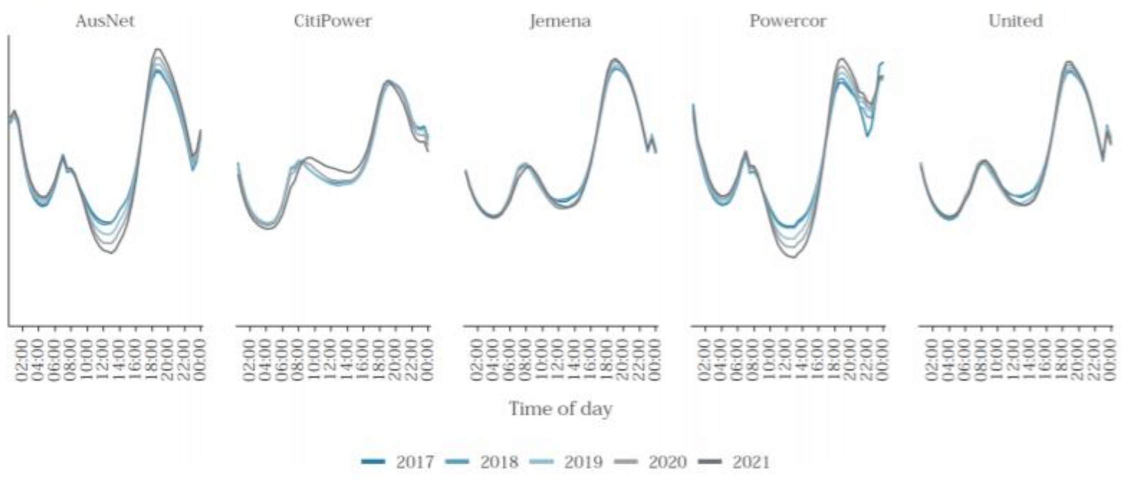
To avoid retailers being exposed to this significant financial risk outside of their control, we request that the ESC recognise not just the weighted trailing average price but also the impact of defaults leading retailer exposure to the penalty cap. This could involve an explicit allowance in the VDO for penalty payments, with a subsequent true-up to reflect actual payments.

Wholesale Costs

Load Profiles

The ESC's has retained its same method using the load and spot price data from five years of historical data from FY2017 to FY2021. However, over that time we consider that load profiles have change as a result of increased solar penetration. We have reproduced the load profile from the Frontier Economics report (p.13).

Figure 3: Average daily profile for residential customers



Source: Frontier Economics analysis of AEMO data

These charts show that the average profile for residential customers is starting to become a lot peakier in the last two years, presumably driven by solar penetration and COVID-19.

As a consequence, the cost of hedging is likely to increase as the load factor deteriorates with retailers bearing more under/over hedging as flat swap products are used to hedge a more sculpted load shape. Specifically, we are faced with a situation where we are buying more caps due to the shape with lower cap payouts.

In addition, the lower consumption volume associated with greater PV penetration will also affect retail cost recovery - a higher unit price being required to recover the same operating costs and margin allowance over a reduced volume.

On this basis, we consider that the recent load data provides a more accurate representation of forecast load. We consider the ESC ought to place more weight on more recent data and consider a 3-year history to account for this change in load profile.

SRES

The ESC proposes to use the same approach to calculating the cost of the small-scale renewable energy scheme as in previous VDO decisions. This includes a true-up to account for the difference in the level of the small-scale technology percentage used in the previous VDO and the actual binding small-scale technology percentage.

The ESC used a non-binding small-scale technology percentage of 19.4 per cent for 2021 and notes in the draft decision that the actual binding small-scale technology percentage for 2021 was set at 28.8 per cent. This equates to a small-scale renewable energy scheme adjustment allowance of $3.80 per MWh (assuming a $40 certificate price) for 2022. However, the draft decision appears to only provide an allowance of $3.40 per MWh (Table B.11). We consider this difference ought to be factored into the VDO allowance.

Network Costs

New network tariffs came into effect from 1 July 2021 while an accompanying variation to the VDO took effect on 1 September 2021. This means that in July and August 2021 retailers' network costs were different to what was included in VDO prices.

The ESC proposes to estimate the amount of under or over recovered costs for July and August 2021 based on actual electricity usage for those two months. The ESC would then allocate this difference to VDO prices for the first half of 2022. The associated under-recovery of costs could then be added to the daily supply charge for all standing offer customers from 1 January 2022.

Origin supports this approach. However, it appears that the proposed cost allowance does not incorporate the retail operating margin. The ESC previously stated that the retail margin applies to all underlying costs[4] and therefore ought to apply to these additional network costs.

Other Matters

Origin requests that the ESC release its decision, determination and supporting all on the same day. This timely and consistent provision of information will strongly assist retailers developing their retail prices in response to the VDO and being able to make these available to customers in an efficient and timely manner.

If you would like to discuss any aspect of this submission, please contact Sean Greenup on (07) 3867 0620 / sean.greenup@originenergy.com.au in the first instance.

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy

[4] ESC (2019), Victorian Default Offer to apply from 1 July 2019, May, p.20.