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20 October 2020

Ms Kate Symons
Chairperson
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Submitted electronically

Dear Ms Symons,

Re: Draft determination - Victorian Default Offer 2021

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make this submission to the Essential Services Commission's (the Commission's) draft determination for the Victorian Default Offer (VDO) to apply from 1 January 2021.

The timing of this determination coincides with a period of significant uncertainty in the competitive retail energy market. Retailers are managing the impact of the COVID-19 pandemic by maintaining supply to their customers, increasing customer engagement with offers of financial support while carrying a growing debt book. Furthermore, the Victorian Government is implementing legislative changes to shift the timing of network revenue and pricing determinations from 1 January to 1 July.

Therefore, it is vital that the Commission take a reasonable approach to calculating the VDO that gives retailers confidence that they will be able to recover their costs. Our submission focuses on two key areas - the need for the Commission to include an appropriate provision for the impact of COVID-19 on retail operating costs; and for the Commission to specify a clear path to aligning the VDO determination date with annual distribution network price changes. Both measures will promote confidence in the Victorian retail energy market and therefore benefit Victorian consumers over the longer term.

Retail operating costs

The Commission uses a benchmark for retail costs as a proxy for efficient costs and then cross checks this allowance against retailers' responses to its data requests. It also makes specific adjustments to that allowance when there is clear and compelling evidence of a need for variation, either positive or negative. We support these variations to the benchmark as an ex ante, rather than ex post, adjustment to the VDO as it allows retailers to recover these costs in the period in which they incur them. The cost of additional obligations on retailers under the Victorian Payment Difficulty Framework is an example where an additional allowance is reasonable and justified.

In our view, the expected impact of COVID-19 on retail operating costs - and more specifically, the impact on retailers' bad and doubtful debt provision - is another cost that should be explicitly accounted for in the next VDO. This is an unforeseen event, the cost of which has been exacerbated by regulatory restrictions on normal industry credit management processes, and its impact was not

factored into the initial benchmark. It is sustained and material, and cannot be avoided through improved operational efficiencies. Red and Lumo acknowledge their role in continuing to provide an essential service during the COVID-19 pandemic to customers who have suffered temporary financial stress, but it is also essential that retailers are able to recover the costs incurred in maintaining that supply and in extending substantial additional credit to customers with no guarantee of repayment.

Retailers' ability to manage their exposure to bad and doubtful debts has been reduced through policymakers and regulators' actions and public statements about how they should respond to COVID-19. While there has not been an explicit prohibition on disconnections for non-payment in Victoria, the Chairperson's letter to retailers on 7 August outlined additional steps that retailers and distributors must take before disconnection can occur which are impossible to fulfil in practice and therefore has the effect of prohibition. This goes beyond the expectations for consumers under the Payment Difficulty Framework that they must stay engaged with their retailer to continue to receive support and avoid disconnection.

At the same time, retailers have changed their practices to support their customers and in response to these regulatory measures. For example, we have removed mention of disconnections from customer communications. As a consequence, some consumers are deprioritising energy payments as there is no longer any consequence of non-payment. The effect of all of these actions has been to restrict retailers' ability to manage customer debt, encourage engagement and entry into payment arrangements if required. This shift in the traditional balance of power between consumers and retailers has resulted in increases in aged debt balances, higher collection risk and provisioning for bad debt which needs to be reflected in the cost to serve allowance in the new VDO.

The issue for the Commission then becomes how to account for COVID-19's impact in a forward looking estimate of efficient costs. Retailers have already been required to make forward provisions for the potential impact (in terms of the likely change in bad and doubtful debt as a proportion of EBITDA compared to business as usual, for example) in line with relevant accounting standards and prudent business management. We refer to provision B5.5.2 in Australian Accounting Standard AASB 9:

Lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk.¹

Therefore, retailers' estimates of the potential COVID-19 impact on bad debts in 2021 can be drawn on by the Commission. These provisions are based on various assumptions about factors such as unemployment rates, measures to address the spread of COVID-19 (i.e. effects of lockdowns and their impact on economic activity), and the timing of the withdrawal of economic support and other stimulus measures.

¹ Compiled Australian Accounting Standards, AASB 9: Financial Instruments, page 71. Available at <https://www.aasb.gov.au/Pronouncements/Current-standards.aspx>

In the draft determination, the Commission refers to its analysis of financial year 2019-20 results published by AGL and Origin Energy, and suggests their provisions for bad and doubtful debts are a 'relatively small share of their total costs'. We disagree that the relevant measure is bad and doubtful debts as a share of total operating costs for these businesses. Analysis of their expected credit losses in their published accounts shows a substantial deterioration in aging of debt and higher provisioning.

Their published accounts and investor presentations for AGL and Origin reveal the movement year on year to end June 2020 in expected credit losses of between \$20m and \$40m respectively due to provisioning for the effects of COVID-19. Red and Lumo's increase in expected credit losses has also now been published within the Snowy Hydro accounts and shows an increase of \$11.8m to \$40.4 million for the year ended June 2020, including forward provisioning for the effects of COVID-19. These are not immaterial increases in retail costs but rather audited assessments of expected bad debts for the next twelve months as at June.

Therefore, we do not agree with the Commission's position in the draft determination that there is insufficient justification to increase the retail operating cost component in the VDO, or that this cost should only fall on retailers, rather than be shared across all consumers. As mentioned, retailers cannot avoid the incremental increase in bad and doubtful debts through efficiency gains, particularly under the current restrictions to long established and acceptable collection practices which already included protections for customers in genuine hardship.

The Commission should appreciate that retailers have not yet realised all of the increase in bad and doubtful debt resulting from COVID-19 and we anticipate these costs will continue to mount in 2021. Provisions for bad and doubtful debts at the end of June were made in an environment of exceptional Government stimulus spending, through the Jobkeeper and the enhanced Jobseeker arrangements. Independent economic analysis by Illion and AlphaBeta (part of Accenture) showed record levels of household discretionary spending.²

At the time, Victoria was expected to emerge from lockdowns by September. Since then the economic environment has worsened, lockdowns have extended into November, Jobkeeper and Jobseeker payments have been reduced. There is a lagged effect of these worse conditions, as consumers are still receiving bills that reflect higher usage over the winter months, further lifted by social restrictions resulting in more time at home, and financial institutions are beginning to review the mortgage payment deferrals offered at the onset of the pandemic. We therefore now expect the provisions recognised in June accounts to increase in the next reporting period.

We recommend the Commission consult with a representative sample of Victorian retailers to better understand the magnitude and assumptions behind their expected adjustment, with a view to including a reasonable increased provision for bad debts in the final VDO. Red and Lumo would welcome the opportunity to be included in this exercise.

This would generate a forward estimate and proxy for future actual costs consistent with the approach the Commission employs for other components of the cost stack. While the inputs are not publicly available market data, similar to the way retailers actual traded wholesale contracts are not

² <https://www.alphabeta.com/illiontracking>

shared, the results would reflect each retailers' compliance with Australian accounting standards and would, in our view, provide a reasonable forward estimate of this cost.

We expect most retailers could provide compelling evidence - both qualitative and quantitative - of how their response to the pandemic has added to their cost to serve. We expect that this will include costs associated with disruption to workplace practices (particularly as energy retailers are largely Victorian based), the additional resources retailers have allocated to handling increased call volumes and the longer discussions we are having with our customers about their circumstances and the support they need.

The Commission will also be aware of the additional steps that retailers must now take to support customers - ongoing obligations with respect to Utility Relief Grant Scheme applications, and other temporary support measures for residential and small business consumers - and the Commission's additional data requests.

Therefore, Red and Lumo strongly support the Commission's decision not to adjust retail operating costs by some productivity factor for the 2021 VDO.

Length of regulatory period

Red and Lumo urge the Commission to reconsider its proposal to set the VDO for a period of 12 months. Our strong preference is for the Commission to outline a clear path to align the VDO determination with the revised data for distribution network revenue and pricing determinations (i.e. 1 July). Two 9 month determinations would provide a clear path and certainty for both retailers and consumers.

Clause 11 of the VDO Pricing Order gives the Commission the flexibility to either increase or decrease the length of the VDO period by up to six months, subject to the Minister's agreement. The Commission should use this flexibility and outline a process to align the VDO and network determination dates over an 18 month period, meaning they will align from 1 July 2022.

This would allow the Commission to take all relevant network issues - such as the level and structure of network tariffs - into account when it sets the VDO. This is important as it will reassure retailers that they can recover all reasonable costs, noting that network costs account for between 35 and 40% of the VDO cost stack, while allowing the Commission to account for any significant changes in network tariff structures.

This is likely to occur as the Victorian electricity distribution networks develop more cost reflective tariffs. As noted in our submission to the VDO consultation paper, SA Power Networks proposed a new solar sponge tariff for controlled load customers at a late stage of the regulatory process, which meant the Australian Energy Regulator couldn't prescribe usage allocations to enable retailers to compare any offers based on this tariff with the Default Market Offer. We want to avoid any similar issues in Victoria, if possible.

The other reason for aligning the VDO and network periods is the combined effect of recent changes to the Energy Retail Code. Under Clause 46AA, retailers may only now increase prices one calendar

month after a network tariff change. This means that retailers would be prevented from changing their prices even if the VDO increased on 1 January since network tariffs change on 1 July.

At the same time, retailers must reference the VDO in various communications, such as advertising, product disclosure statements and scripts for when they discuss offers with actual and prospective customers. They would need to amend all these documents and scripts, even though the majority of customers on market offers would not be experiencing a price change. We would prefer to align the timing of the various obligations and processes that a price change usually requires.

We agree with the Commission that it will not receive final network tariffs and structures for the Victorian distribution networks in time for a 1 July VDO. A reasonable solution would be to set the VDO for 9 months from 1 January which would allow the Commission to take the new network revenue period into account in the next VDO period. The Commission would then set the next VDO with a view to aligning with the annual network tariff change date from 1 July 2022.

We recognise this goes against the policy objective to set the VDO for a period of 12 months. It will also require careful explanation to consumers. However, it is a reasonable but necessary measure to align the respective regulatory periods and address the other implications of recent changes to the Energy Retail Code.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, South Australia, New South Wales, Queensland and the ACT to over 1.1 million customers.

Red and Lumo thank the Commission for the opportunity to comment on the draft determination. As noted, we would welcome the ability to discuss the submission, including the impact of COVID-19. Please call Geoff Hargreaves, Regulatory Manager on 0438 671 750 to organise this discussion or to discuss aspects of this submission.

Yours sincerely

A handwritten signature in black ink, appearing to read "Ramy Soussou". The signature is stylized with loops and a long horizontal stroke at the end.

Ramy Soussou
General Manager, Regulatory Affairs & Stakeholder Relations
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