Essential Services Commission
Level 8, 570 Burke Street
Melbourne Victoria 3000
By email VDO@esc.vic.gov.au

19 April 2024

Victorian Default Offer 2024–25 Draft Determination

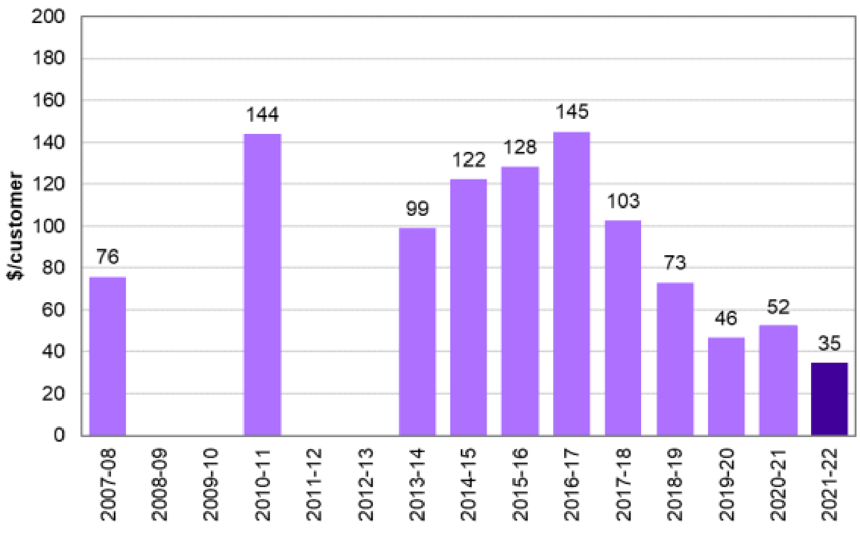
The Australian Energy Council ('AEC') welcomes the opportunity to make a submission on the Essential Service Commission's ('AER') *Victorian Default Offer 2024–25 Draft Determination.*

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.

Retailers have been competing in a highly volatile and challenging environment as the below graph from the ACCC shows:[1]

Figure 4.5: Retail margins in 2021–22 declined to the lowest on record

Average retail margins (as earnings before interest, tax, depreciation and amortization or EBITDA) per residential customer across the NEM, 2007–08 to 2021–22, real $2021–22, excluding GST



Source: ACCC analysis based on retailers' data.

The AEC understands the balance the ESC needs to find when setting the VDO price, between protecting customers from unreasonably high prices and ensuring investors are compensated for the capital they provide retailers. The AEC considers that in recent years the retail market is becoming increasingly unattractive as a site for equity investment. The AEC notes the record levels of Retailer of Last Resort events over the last year and that as the Australian Energy Regulator (AER) noted in its *State of the Energy Market Report 2023*, the market remains vulnerable to supply or demand shocks:

[1] ACCC (2022) Inquiry into the National Electricity Market – November 2022 Report at https://www.accc.gov.au/about-us/publications/serial-publications/inquiry-into-the-national-electricity-market-2018-25/inquiry-into-the-national-electricity-market-november-2022-report p.73

Level 14, 50 Market Street
Melbourne 3000
GPO Box 1823 Melbourne Victoria 3001

P +61 3 9205 3100
E info@energycouncil.com.au
W energycouncil.com.au

ABN 926 084 953 07

> *While wholesale prices have subsided since a peak in 2022, the market remains vulnerable to supply or demand shocks. Reliability issues with coal-fired generation assets and managing the increasingly peaky shape of customer demand could also put upward pressure on wholesale costs.*[2]

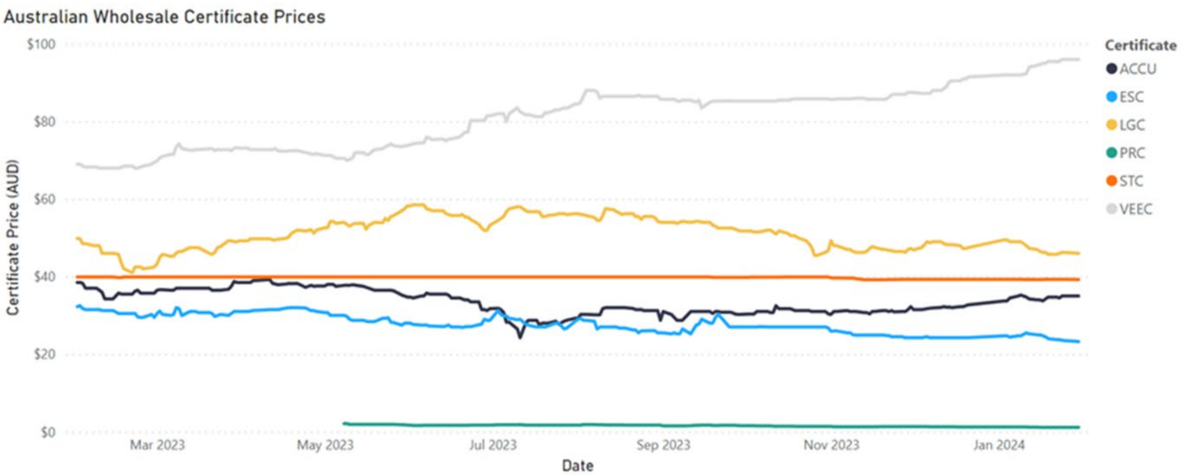
The AEC believes that it is important for the ESC to ensure that the VDO 2024-25 adequately supports the retail market investing environment.

The AEC addresses key consultation questions below.

Network prices
The AEC supports the Origin Energy submission that in the event network prices approved by the Australian Energy Regulator are not available to incorporate into the Victorian Default Offer pricing determination, the Commission should use the 2024–25 network tariffs submitted for approval by the Victorian networks as the next best alternative. We agree that any differences between the proposed and approved network tariffs should be accounted for by applying a true-up mechanism in future years.

Victorian Energy Efficiency Certificates
The AEC believes Victorian Energy Upgrades scheme costs are underestimated: an input of $77 for Victorian energy efficiency certificates (VEECs) is well under the current market price. The ESC has used a trade weighted 12 month estimate up to 31 Dec 2023 so this must be refreshed and it is not clear how the ESC accounts for retailers who are paying the penalty of $95 because of the current problems with the administration of the scheme – for example, certificate creator insolvency or suspension.

VEEC costs have steadily trended upwards since 2020, when certificates were around $30, to the current price of $96. The below graph shows the VEEC price trajectory over the past year, compared to other schemes.



Source: https://northmoregordon.com/certificate-prices/

The main drivers of VEEC costs are:

Constraints on creation of activities

- The primary activity under the VEU was lighting installations, which comprised around 80 per cent of registrations in 2021.

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[2] AER (2023) State of the Energy Market at https://www.aer.gov.au/publications/state-of-the-energy-market-reports/state-of-the-energy-market-2023 p.230

- Government reforms have seen lighting activity phased out and not adequately replaced by other activity.
- The Department of Energy, Environment and Climate Action (DEECA) has promised to rollout new activities, but this is not occurring fast enough.
- Many new activities are more administratively burdensome, resulting in slower certificate creation.
- Other reforms (e.g. door knocking ban) have further suppressed supply.
- ESC is registering certificates slower than the stated timeframe (currently over 650,000 pending registrations).

Annual increases to demand

- There are enshrined certificate targets in legislation that increase each year (along with the electricity emissions factor going down) despite the supply issues above.

Inefficient price signals

- Due to the high spot price, some accredited parties (APs) are defaulting on forward contracts and being unwilling to enter into new forward contracts.
- DEECA has said previously that there is enough supply to meet annual demand. While true, it does not provide liquidity or an ability for retailers to hedge/smooth costs – a primary retail function.

In light of these deficiencies, the ESC needs to consider whether its allowance is enabling participants to fully recover their costs.

Retail operating margin

The AEC notes that for the 2023–24 Victorian Default Offer, the ESC set the retail operating margin at 5.3 per cent based on benchmarks set by other regulators and having regard to the expected returns model. The AEC proposes that the ESC make explicit its assumptions in determining the 5.3%, so that there is more transparency about what EBITDA the ESC is targeting and how it makes its selection within the range of observed variables. With respect to the other regulators that the ESC uses, the AEC does not believe they are comparable market environments.

The AEC does not support the decision the ESC made to reduce the retail operating margin from 5.7 to 5.3 per cent, between the 2023-24 Victorian Default Offer Draft and Final decisions. In doing so, the ESC cited several reasons for this reduction:

- "since 2020, most retailers have offered market offers below, and sometimes well below, the Victorian Default Offer
- retail margins set by other regulators have decreased
- additional retailers have sought to enter the market
- 5.3 per cent is within the range of retail margins produced by the expected returns approach
- on average, retailers' reported retail margins have decreased."[3]

The AEC notes the following responses to the ESC's arguments:

- the effectiveness of how the market has performed under the VDO cannot be fully understood by looking at advertised offers as these are often bigger discounts that are targeted to new customers and can be considered acquisition offers. Instead, a range of competition metrics should be reviewed that include the number and nature of market participants, market concentration, and the recent financial performance of retailers. This analysis should consider

[3] ESC (2023) Victorian Default Offer 2023-24 Final Decision at https://www.esc.vic.gov.au/electricity-and-gas/prices-tariffs-and-benchmarks/victorian-default-offer p.48

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E info@energycouncil.com.au
W energycouncil.com.au
ABN 926 084 953 07

prices charged at fixed intervals because this will capture a range of margins and will reflect the prices retailers are willing to charge and the margin they are willing to receive rather than point in time discounts.

- with respect to the other regulators that the ESC uses, the AEC does not believe they are comparable market environments.
- while some new retailers have sought to enter the market in 2022 and 2023, there has been a higher proportion of exits and the entries have significantly declined since mid-2022.
- while 5.3 per cent is within the range of retail margins produced by the expected returns approach, it does not account for changes in the market environment including the high interest rate environment which has emerged as more than a short-term change. The AEC believes that the increase in financial cost should be reflected in the retail operating margin.

The AEC therefore proposes that the retail operating margin be set at 5.7 per cent for VDO 2024. Reinstatement demonstrates a return to standards upheld in previous reviews, which were long considered by the ESC to be appropriate.

Any questions about this submission should be addressed to Jo De Silva, General Manager Retail Policy by email to jo.desilva@energycouncil.com.au or by telephone on 03 9205 3100.

Yours sincerely,

Jo De Silva

Jo De Silva
General Manager Retail Policy

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