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Lodged online: https://engage.vic.gov.au/victorian-default-offer-2021

21 July 2020

Victorian Default Offer price review 2021

The Australian Energy Council (the '***AEC***') welcomes the opportunity to make a submission to the Essential Services Commission (the '***ESC***') on its *Victorian Default Offer price review 2021 Consultation Paper* (the '**Consultation Paper**').

The AEC is the industry body representing 22 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

At a high level, the AEC is comfortable with the ESC's proposed approach to setting the 2021. That being said, there remain a number of key amendments to the methodology necessary to ensure the Victorian Default Offer (VDO) meets its objectives.

The role of the VDO

The Victorian Government has made clear over a number of years that the VDO is intended to represent a simple, trusted, and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity market in Victoria.[1] While the approach to setting the price is left open by the Government, the AEC does not consider the ESC's current approach to setting the VDO aligns with its long-term objective.

The AEC has provided significant evidence during consultations on the 2019 and 2020 VDO that make clear that the ESC's approach is not best practice, nor does it adequately compensate retailers for the risks they are expected to manage in the electricity market.

The VDO is not intended to be the cheapest price in the market. While the AEC accepts that the Government has determined to set a fair price for electricity that does not provide any headroom, there are significant risks to consumers for setting a price in a manner that does not allow retailers to recover their efficient costs. While price setting is not an exact science, the AEC contends that setting the price too low is of greater risk to energy consumers as a whole than setting the price too high. While a small number of consumers who are unable or unwilling to engage in the market might be slightly worse off, this will be countenanced by the vast majority of energy users who are able to benefit from engaging in the electricity market.

[1] http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S208.pdf

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This submission will highlight a number of modifications to the ESC's approach that would ensure electricity retailers are able to recover their costs, without unreasonably disadvantaging the customers currently benefited by the VDO.

Wholesale Electricity Costs (WEC)

The setting of the WEC represents the greatest risk for electricity retailers. While network and retail costs are largely fixed, an incorrect assessment of the WEC creates existential concerns for retailers, in particular smaller standalone retailers who do not have direct access to generation.

As part of the consultation process for the 2020 VDO, the AEC engaged ACIL Allen to undertake an assessment of a number of key assumptions taken by the ESC in making its Draft Decision. ACIL Allen made a number of key recommendations to the ESC that would decrease the risks faced by electricity retailers, and better achieve the objective of the VDO.

Of particular concern to the AEC is the approach of the ESC to set the WEC based on the median load weighted price. ACIL Allen suggested that instead, the WEC should be selected based on the distribution of simulated prices, rather than a simulation that gives the median load weighted price.

While steps by Frontier to make the WEC more transparent are welcomed, the AEC does not agree with Frontier's characterisation of ACIL Allen's proposed reasonable risk mitigation as "allowing retailers to over-recover their wholesale costs 95 years out of 100".[2] It is incumbent on the ESC to ensure that retailers are able to recover their efficient costs. Using the 95th percentile instead of the 50th to set the WEC would mean that for the vast majority of years, retailers would be able to compensated fairly. Using the Frontier methodology there is a 50% likelihood that retailers will be undercompensated for the WEC, with no means of mitigating that risk.

The AEC considers that if the ESC were to maintain its current approach – in which retailers were unable to cover their wholesale costs every second year – the risks of damaging the competitive market, and disadvantaging the vast majority of customers who are engaging in that market would be high.

Network costs

The AEC acknowledges the Victorian Government's desire for the VDO to provide a single, easy to that understand electricity tariff for customers who are unable or unwilling to engage with the market.

Given the vast majority of customers in Victoria are currently on flat network tariffs, the AEC is comfortable with the ESC continuing its 2020 approach to set a single flat VDO, and base the controlled load and maximum annual bill for time varying tariffs off this flat VDO rate.

However, this approach does mean that retailers are exposed to costs that differ from those included in the VDO methodology where a customer opts onto the flat VDO, yet their underlying network tariff is time varying (or even includes a demand component).

As network tariffs become increasingly cost reflective in the next regulatory period, the AEC expects this issue to become material. The most effective approach to achieve the Government's intent (without requiring additional compensation for retailers unable to mitigate their costs), is to require network businesses to change a customers non-flat network tariff to a flat tariff, should the customer opt into the VDO. Under the current framework, each network business is able to determine its own rules around tariff assignment. The

[2] Frontier Economics, Wholesale Electricity Costs – a report for the Essential Services Commission, November 2019, p.41.

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AEC considers an obligation should be imposed to align these tariffs through either the Electricity Distribution Code, or by the Government through their order-in-council powers.

In future years, the AEC expects retailers will be more exposed to cost reflective network tariffs by default, so there may be a need for the ESC to reconsider its approach to valuing network costs in the VDO. While the above recommendation to align network tariffs when customers opt into the VDO would mitigate these costs, it is important that the efficiency benefits from the transition to more cost reflective network tariffs are not lost due to the presence of the flat VDO.

Environmental costs

The AEC maintains that a contract based approach to quantifying a retailers efficient LRET costs would be preferable to the ESC's proposed market price approach. It is incumbent on retailers to act prudently to ensure they are able to meet their regulatory obligations, and suggesting that retailers would be better served buying all certificates necessary at once does not reflect that reality.

Whilst the AEC accept there are challenges to identifying efficient costs in a contract based approach, these costs can be modelled relatively easily using publicly available data and some assumptions as to how an efficient retailer might contract over time to meet their obligations under the scheme. For example, the AEC would support the ESC developing a weighted average of LGC prices, weighted by market share. This would enable retailers with large LRET liability to receive a fair value in the VDO to account for their renewable investments over time, without disadvantaging those retailers that utilise the forward markets to purchase certificates. The AEC understands that the ESC could obtain public data on LGC holdings from PPA announcements to support this weighted average approach.

With regard to SRES costs, the AEC supports the approach of the ESC to include an adjustment in the VDO to account for the lack of data on a retailers liability for the coming year. We acknowledge that this limitation is not within the control of the ESC, and consider that provided the approach is maintained irrespective of a decline or increase in liability, it is the best available compromise in determining efficient costs. In any event, this issue will likely be resolved by the shift to setting the VDO for a financial year from 2021/22.

The AEC expects the costs of complying with the Victorian Energy Upgrades scheme will increase dramatically in 2021. As foreshadowed prior to the COVID-19 pandemic, the Government has flagged its intention to increase the number of certificates required to be surrendered by retailers, while at the same time limiting some certificate creating activities. Given the impost of the pandemic, any changes to the scheme were postponed from 1 July 2020, however unless there is a change in position, the AEC expects these changes to be implemented in FY21.

Depending on the length of the next VDO period, this change will have significant impacts on a retailers efficient costs, and the AEC considers that an adjustment is necessary to take into account the likelihood of a mid-year increase. This could be undertaken in a similar manner to the adjustments made regarding the costs of the SRES.

Regulatory costs

The AEC supports the ESC's approach to compensating retailers for AEMO fees, Ancillary fees, and the RERT. The Consultation Paper suggests the ESC will use an average of the 2018/19 ESC fees to set the VDO. The AEC assume this is an error, and an average of the 2019/20 fees will be utilised for the 2021 VDO.

With regard to other regulatory costs, the AEC note that the ESC's proposed position on the costs of implementing five minute settlements (5MS) is no longer current following the decision of the AEMC to

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implement 5MS in October 2021. In 2019, the AEC surveyed its membership to attempt to quantify the costs of implementing 5MS.

While these costs cannot be solely attributed to retailers and the delivery of energy to Victorian consumers, they do highlight the significant cost impacts of implementing 5MS on retail businesses. These costs are efficient, with the AEMC identifying that in the long term, the benefits to consumers outweigh the implementation costs. The AEC considers that the ESC should include an allowance, on a per customer basis, for the costs of implementing this reform.

Retail Operating Costs

The AEC considers that further work is needed during this VDO consultation period to assess the impacts of the substantial regulatory reform program that has taken place in the retail market over recent years, when compared to the benchmark years used as the basis for setting the Retail Operating Costs (ROC) in the VDO.

The Consultation Paper proposes to utilise the ROC allowance from the 2017 ICRC pricing decision in the ACT. Whilst the AEC accepts the ICRC decision is the most recent pricing decision that might be able to be relied upon by the ESC in 2021, there are few similarities between this decision and the ROC faced by retailers today.

The ESC is aware that since 2017, the Victorian regulatory framework has diverged dramatically from that considered in the ACT decision. In recent years, retailers in Victoria have implemented:

- The Payment Difficulty Framework
- Best offer notifications on bills
- The clear advice entitlement
- Clear and fair contracts reforms
- Family Violence reforms
- Increased back-billing limitations

In addition, the ESC is considering further reforms to be implemented in the coming months to expand the payment difficulties framework to small business customers in response to the coronavirus pandemic.

These reforms result in a fundamentally different regulatory environment facing electricity retailers in Victoria when compared against other states. It is important to note that all of these reforms have been implemented after the ACCC found that the costs of retailing energy in Victoria were $11 higher than those in other jurisdictions (such as the ACT). For this reason, the AEC considers the $10 allowance included in the 2020 VDO was inadequate, and should be increased significantly to allow retailers to be recover their efficient costs, including the costs of implementing regulatory change.

Other retail costs

The AEC is concerned about the significant increases in complaint costs in the 2020 financial year, that retailers are not compensated for under the existing VDO methodology. Whilst complaint costs might not ordinarily be classified as efficient, of concern to the AEC is the increases in individual complaint costs, to enable the scheme to recover its costs in an environment where retailer complaints are falling. It is important that retailers are incentivised to reduce their complaint numbers, and therefore reduce their overall costs. However, in 2020, individual EWOV complaint costs increased by 25-35%, resulting in a material cost increase to retailers that they are unable to mitigate. The AEC contends that an allowance for these additional costs should be recoverable under the VDO.

Coronavirus impacts

While the full extent of the COVID-19 pandemic on retailers will not be known for some time, the AEC considers there is a need to ensure that retailers are able to recover their expected efficient costs. As retailers hold all cash-flow and non-payment risk for the entire electricity supply chain, it is imperative that the upstream costs retailers face are able to be recovered from their customers.

Of greatest concern to the AEC is the increase in bad debt costs. Customer non-payment is borne solely by the retailer, and does not reduce in any way the other costs facing retailers as described in the Consultation Paper. While other costs are relevant (for example, increases in ROC driven by increased customer engagement and requirements to change the operating structure of contact centres to allow working from home), these costs pale into insignificance when considered against the increase in bad debts retailers are anticipating over the coming 12 months.

So as to model these expected costs, the AEC proposes that the ESC seek to estimate the predicted rate of non-payment, driven primarily by the Victorian unemployment rate and any ongoing limitations on retailers ability to recover debts over and above what is in the regulatory framework.

In practice, the Victorian payment difficulties framework was intended to provide support for all energy consumers, however was based on an estimate that the number of customers needing that support held relatively consistent over time. Official unemployment figures increased from 5.2% in May 2019, to 7.1% in May 2020. When the number of customers not actively looking for work, and those working zero hours but supported by the JobKeeper scheme are accounted for, it is estimated Australian has an effective unemployment rate of 13.3%.

This effective unemployment estimate represents a 150% increase in the number of customers likely to experience payment difficulties due to unemployment than retailers would normally assist. In addition to this increase in customer numbers, retailers have also been significantly inhibited in their ability to collect on their debts during the COVID-19 pandemic. The ESC has reported that since March 2020, there have been virtually no disconnections for non-payment in Victoria. Given the presence of stage 3 stay-at-home restrictions in Melbourne during July and August at least, the AEC does not expect disconnections for non-payment to be undertaken for some months to come. The PDF is predicated on the fact that after a customer exhausts all entitlements to assistance, retailers are able to disconnect for non-payment, provided the energy debt is greater than $300. In 2018/19, energy retailers disconnected more than 40,000 customers for non-payment. Of these customers, 47% were reconnected in the same name – indicating 53% moved to another retailer to get their service reconnected. The AEC considers that these customers who switched retailer after disconnection, are less likely to be those facing payment difficulty, and more likely to not be engaging with their existing retailer during the pandemic. It is likely that these customers are currently incurring energy debts retailers are unable to mitigate.

The AEC considers that the ESC could model the impact of the COVID-19 pandemic on retailer costs using the following key metrics, and include an allowance for the VDO that takes into account these expected cost increases:

1. The percentage of customers effectively unemployed in Victoria in 2020, compared with 2019
2. The cost imposts on retailers of providing assistance to these additional customers
3. Any limitations on a retailers ability to efficiently mitigate increased debts
4. The likely percentage of these customers that will not pay their energy debts

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Other considerations – length of the regulatory period

The AEC considers that given the uncertainty facing retailers caused by the COVID-19 pandemic, a six-month VDO represents the best outcome for consumers. A six-month VDO would enable the ESC to better assess the impacts of the pandemic on retailer costs, and therefore mitigate the risk premium required to ensure retailers are able to recover their efficient costs.

The AEC acknowledge that this approach will likely result in two price changes for Victorian consumers, but given the decision of the Government to change the network price period, this negative experience is unavoidable. Undertaking an 18-month VDO would require the ESC to estimate the impacts of network costs in a future period, in addition to making long range predictions on other key cost drivers – materially increasing the risks the VDO would be over or undervalued for the 2021/22 financial year. These risks outweigh the negative experience caused by an additional mid-year price change for consumers.

The AEC welcomes the opportunity to continue to work with the ESC to ensure that the 2021 VDO enables retailers to recover their efficient costs, particularly given the changing economic environment in Victoria. For any questions about our submission please contact me by email at ben.barnes@energycouncil.com.au or on (03) 9205 3115.

Yours sincerely,

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