AUSTRALIAN ENERGY COUNCIL

Essential Services Commission
Level 8, 570 Bourke Street
Melbourne Victoria 3000

Submitted online.

30 January 2023

RE: Victorian Default Offer 2023-24

The Australian Energy Council (AEC) welcomes the opportunity to make a submission to the Essential Services Commission's (ESC) *Victorian Default Offer 2023-24 Consultation Paper* ('Consultation Paper').

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.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations and will focus on the issues raised in this Consultation Paper. It does not consider the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised in their own submissions.

The AEC's submission to the *Review of the Victorian Default Offer* in April 2022 cautioned that the energy market is likely to become volatile in the coming years, and that this will make price regulation more challenging. This volatility is now very real and is leading to higher electricity prices, as well as placing significant pressure on retail viability.

The financial pressures retailers are facing was recently laid out in the ACCC's *Inquiry into the National Electricity Market – November 2022 Report* ('ACCC report'). The AEC has used this report to inform this submission. In short, the ACCC identified multiple market factors impacting retailer viability:

- High and volatile wholesale electricity spot prices
- High contract prices, exacerbated by reduced access to hedging contracts
- Need to absorb substantial compensation costs associated with the June 2022 energy events
- Retail price caps limiting the ability of retailers to manage costs, increasing their liquidity risk.

The ACCC subsequently recommended that the ESC take these circumstances into account when reviewing the Victorian Default Offer (VDO), warning that 'regulated retail pricing affects the ability of retailers to recover their costs and remain financially viable. It is important that regulated pricing reflects the actual costs of operating in the market, including the costs of managing price risk'.[1]

[1] ACCC, 'Inquiry into the National Electricity Market', November 2022 report, p4, https://www.accc.gov.au/system/files/Inquiry%20into%20the%20National%20Electricity%20Market%20-%20November%202022%20report.pdf.

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UK experience shows how important it is to get price regulation right
The United Kingdom recently saw the collapse of its retail electricity market. This collapse was driven by unreasonable price caps stymieing the ability of retailers to recover their costs, eventually leading to a domino effect of retailers falling over. The UK Government was forced to announce a $AU233 billion support package for customers to manage their electricity bills. There have been some tentative warnings about Australia repeating the UK's experience, and the AER has reported a significant increase in the number of ROLR events.

So far, these ROLR events have only affected around 0.3 percent of the retail market.[2] However, capped prices which do not adequately consider energy supply chain (including retailer) viability, risk triggering a market crisis.

While the ESC has stated its intent not to change the VDO methodology, the AEC remains concerned that parts of the methodology might be interpreted differently to meet a particular policy objective.

The challenge for the ESC (and other price cap regulators) is to avoid overreach and reactivity, by implementing mechanisms attuned to market conditions which promote incremental timely response for stable retailer viability alongside customer needs.

1. Use of futures market approach to benchmark wholesale costs
The AEC notes the ESC's proposal "to continue to use trade-weighted futures contract prices for the most recent 12 months available" in setting the VDO wholesale energy cost (WEC) benchmarks.

For *the 2023-24 period*, the AEC's view is that the WEC benchmark should continue to use trade-weighted futures contract prices with an additional allowance applied for updated retailer margining costs.

Furthermore, given the trends and high volatility experienced in the wholesale market, the AEC suggests that the ESC should conduct tests (using real historical data) to evaluate the adequacy of modelling methods applied and resultant volatility risk premium determined. That is, using the data available to the ESC when setting the 2022-23 benchmark, was the market volatility and price actually experienced in the market within the ESC's 'worst case' modelled outcomes used to derive the VDO volatility premium?

In "Recommendation 2" of the ACCC's report (which is, in part, directed to the ESC), it emphasises the importance of regulated prices accurately reflecting market hedging costs – including impacts from (i) market shifts towards OTC contracts and (ii) the significant increased cost of margining and collateral.[3]

(i) Market shifts towards OTC contracts
The AEC notes the importance of the VDO WEC benchmark accurately reflecting efficient retailer costs – considering customer load shape, level of participant integration synergy and market fuel mix. The AEC also acknowledges the complexity involved and effort required from both the ESC and retailers to include a (volume-weighted) assessment of OTC transactions in the VDO benchmark determination.

With the planned expansion of the AER function to include monitoring (and data collection) of the OTC market[4] - and provided that transparency and predictability is achieved in the manner in which

[2] Australian Energy Regulator, 'Default Market Offer Prices 2023-24 Issues Paper', November 2022, p7, https://www.aer.gov.au/system/files/AER%20-%20Default%20market%20offer%20-%20Price%20determination%202023-24%20issues%20paper%20-%203%20November%202022_0.pdf.
[3] ACCC report (n1), p6.
[4] ibid

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the AER reports on its monitoring - it is the AEC's view that the ESC should leverage the expanded AER function to monitor developments in the volumes and prices transacted OTC in future years.

That said, the AEC considers that the ESC should only adapt its assessment methodology to include OTC impacts if omitting OTC values would derive a materially inaccurate WEC and participants are adequately consulted on any proposed methodology change. Any such ESC OTC monitoring or inclusion process (including timing of implementation) should carefully avoid onerous data disclosure by retailers by finding synergies with the AER's expanded function.

As the AER expanded function is not yet implemented, for the *2023-24* VDO benchmark process, the AEC supports the continued use of the Energy ASX.

(ii) Cost of margining

It is unclear where in the ESC's VDO's methodology provides for retailer margining costs – across the WEC and other benchmark components. The AEC notes that the Australian Energy Regulator's (AER's) Default Market Offer (DMO) provides some allowance for Energy ASX initial margining (albeit not variation margins).[5]

With heightened growth in margining requirements in 2022, any VDO deficiency now represents a material gap in the benchmark for efficient retailers.

In the interests of transparency, the ESC should describe clearly which element of the VDO benchmark accommodates retailer margining costs and the methodology used to update for the period. In the interests of accuracy, it is the AEC's view that the ESC's methodology for including (and updating) margining costs should consider recent significant increases in retailer margining requirements.

2. Views on how costs resulting from the June 2022 market intervention should be reflected in the VDO prices

The AEC notes the ESC's acknowledgement that there are two components of market intervention costs an efficient retailer would reflect in customer pricing - generator compensation costs (to be incurred by retailers via AEMO charges) and direct retailer impacts - by way of foregone hedging revenue.

To ensure equitable cost recovery from customers, it is important that the VDO price includes these cost elements as close as possible to the intervention event. The AEC is of the view that 2023-24 benchmarks should reflect market intervention costs to the extent they are calculated at that time plus an estimate component for amounts yet to be fully assessed with 'true-up' values applied in the 2024-25 year. Given the material value of these costs, excluding estimates in the 2022-23 year, would inappropriately burden retailers with the cost of timing differences and cost-revenue mismatch risks associated with shifts in customer portfolios through churn, acquisition and contract switching.

In the event that the ESC does not apply an 'estimate-true-up' approach for the market intervention costs over the 2023-24 and 2024-25 years, the ESC should apply an uplift to the retail margin benchmark to compensate retailers for their increased capital funding and risk of variations to customer portfolios connected to these costs.

[5] ACIL Allen, 'Default Market Offer 2022-23 -Wholesale energy and environment cost estimates for DMO 4 Final Determination'. May 2022, p80.

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3. Views on benchmarks for retail operating costs and customer acquisition and retention costs
In the AEC's view, use of the CPI to determine the retail operating cost (ROC) and customer acquisition and retention costs (CARC) benchmarks should be maintained.

While there are factors driving CPI uplifts which do not directly impact ROC and CARC (e.g. food prices), there are counter-balance drivers not captured in CPI which are currently escalating retailer costs.

Counter-balance drivers largely relate to community economic pressures, which are expected to be multi-faceted in the next period. In addition to cost-of-living increases (per CPI), interest rate rises (with low fixed rates rolling off) and the Australian Taxation Office (post pandemic) ramp-up in debt collection will flow through the economy impacting both residential and SME customers. These pressures come to bear on retailer costs through higher bad debt provisions / write-offs and higher staff headcount to cope with increased activities in revenue collection, hardship program through-put and customer call centre activities.

The AEC supports the ESC's principles-based approach to considering the most appropriate assessment method. The AEC recommends the adoption of an additional, *cost-effective* principle: the method can be determined and communicated by the regulator in a timely and cost-effective manner.

The AEC does not support a ROC or CARC benchmark reset, for this determination period, given the complexity, cost and effort involved in retailer data collection and analysis (relative to the likely marginal change in benchmark values). Switching to an alternative basket of indexes will also be complicated and costly and may not deliver improved accuracy (when compared to CPI). Applying the wages index is likely to deliver less accuracy as retailer costs drivers go beyond wages to a material extent.

Considering the need for an efficient, transparent, simple and stable benchmark method coupled with the cost drivers counter-balancing CPI reflectivity, the application of CPI should be maintained.

While the AEC does not support a move away from CPI, if the ESC is committed to a new method, then the AEC's preference would be a blend of CPI and wage indexation based on a split of retailer labour versus non-labour costs reported by retailers. The AEC notes that this approach would likely under-compensate retailers for expected workforce headcount increases in their call centres, debtor management and hardship program areas.

4. Views on the cost impact of the consumer data rights on retailers

Confidential information – do not publish
Tier 1 retailers commenced CDR obligations on 15 November. The average costs of implementing the CDR ecosystem for small customers [redacted] These costs do not include annual operating and maintenance costs or future implementation costs, which are both likely to be significant. The AEC considers the known costs to be material and should be reflected in the VDO.

The AEC is open to explaining the breakdown of these costs to the ESC, noting that this figure has been collated confidentially and is not known to AEC members, in accordance with CCA obligations.

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5. Should the ESC continue to publish VDO Consultation Papers each year?

Given the dynamic nature of the energy market in current times with multiple international and domestic factors impacting actors in the system, ESC processes should encourage system agility and responsiveness. As such, the ESC should continue with the Consultation Paper process to provide stakeholders the opportunity to engage.

Any questions about this submission should be addressed to Jane Sing, by email to jane.sing@energycouncil.com.au or by telephone on (03) 9205 3100.

Yours sincerely,

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