AGL Energy Limited
T 02 9921 2999
agl.com.au
ABN: 74 115 061 375

Level 24, 200 George St
Sydney NSW 2000
Locked Bag 14120 MCMC
Melbourne VIC 8001

Victorian Default Offer 2025 – 26: Draft Decision

Essential Services Commission

Submission via engage.vic.gov.au

14 April 2025

AGL Response to Victorian Default Offer 2025 – 26 prices: Draft Decision

AGL Energy (**AGL**) welcomes the opportunity to comment on the Victorian Default Offer (**VDO**) prices 2025 – 26 Draft Decision (**Draft Decision**).

We do not support the step change imposition of material changes to the methodology used to calculate wholesale costs with no period of adjustment (particularly in combination with a decision to reduce the retail margin). The cumulative impact of these changes artificially reduce the VDO, masking real and sustained increases in input costs. This risks undermining competition, retail viability, and so the ability to fund necessary ongoing investment required for the energy transition. We would support a phased transition to the proposed methodology to account for distributed solar combined with full recognition of actual costs of solar exports. This should be phased in to smooth the impact consistent with good regulatory practice.

It is critical that the VDO is set at a level which allows retailers to earn a reasonable return to remain viable and facilitate continuation of competition that has benefitted consumers. Major cost components, including network costs, continue to increase due to long term structural factors. Retailers cannot mitigate the future risk of network cost increases. Addressing those factors is key to ensuring the costs faced by retailers in the future are appropriately managed, as those costs will be reflected in the VDO.

Attached to this letter is our response to the draft determination. In summary we:

- Are concerned with the VDO's lack of consideration of preserving retail viability, market competition and the long-term interests of consumers
- Disagree with the decision to reduce the retail margin from 5.3 to 5 percent and encourage the ESC to reconsider in light of broad economic uncertainty and the strong competitive dynamic in Victoria.
- Strongly recommend the ESC implement a phased change to the import only representative load profiles.
- Support further assessment of the implications of actual costs of solar exports to support a phased transition to the new import only representative load profile
- Reiterate our concern that the VDO methodology does not reflect the future costs and risks of compliance with the Victorian Energy Upgrade program.

If you have any queries about this submission, please contact Kyle Auret on [redacted] or [redacted].

Yours sincerely,

Ralph Griffiths
General Manager, Policy and Market Regulation

Attachment: AGL response to the 2025-26 VDO draft determination

About AGL

Proudly Australian for more than 185 years, AGL supplies around 4.5 million energy services. AGL operates Australia's largest private electricity generation portfolio within the National Electricity Market (NEM), comprising coal and gas-fired generation, renewable energy sources such as wind, hydro and solar, batteries and other firming technology, and gas production and storage assets. We are building on our history as one of Australia's leading private investors in renewable energy to now lead the business of transitioning to a lower emissions, affordable and smart energy future in line with the goals of our Climate Transition Action Plan.

Purpose of the VDO and the information it provides

The VDO has two important purposes: to establish a regulated safety net by limiting standing offer prices and to set a comparison reference price for consumers for market offers. In undertaking the regulatory process to set the VDO, the ESC provides an independent assessment of the cost components of a representative retailer's costs of supply, which include wholesale market, network, environmental and retail and other costs.

In the context of the continued cost of living pressures, this information provides important public transparency on the material cost drivers that are impacting customer bills. A consistent and transparent methodology is essential. In addition to informing the standing offer and reference price for customers, the ESC's independent assessment should inform government decision makers of those cost drivers, thus assisting to guide public policy which may reduce the underlying cost components.

The recent draft VDO methodology changes mask the impact of changes in key electricity cost drivers, notably increases in network and wholesale costs. These sudden methodology changes are to the detriment of retail competition and an efficient retailer market return. Retail competition is a central feature to future energy services and product innovation, as CER evolves.

We note that the fundamental cost drivers are structural and cannot be addressed or suppressed through the VDO. Sustainable reductions in prices will require sustainable reductions in the cost of supply. Network costs continue to grow quickly, primarily driven by a higher rate of return and inflation. Wholesale costs have moderated since their peak, however sustained investment in new generation, storage and firming is required to transform the system and replace aging generators. Effective integration of customer energy resources and the right long term market design settings continue to be critical.

The focus on customer affordability must shift to addressing cost drivers in network and wholesale costs. Network costs are expected to continue to grow, particularly for transmission augmentation.

We also consider that the VDO should not disincentivise customer engagement. Engaging in the market allows customers to select a product well suited to their needs, thus driving retailer innovation which ultimately benefits all consumers as part of the competitive process. If the VDO is set too low, this risks retailers being unable to make market offers with material discounts from that reference price, thereby disincentivising customer engagement. The ACCC has observed:

> *"as the market continues to evolve, market bodies and state and federal governments should ensure that our regulatory framework remains effective in supporting <u>meaningful consumer engagement</u> and*

providing the necessary levels of consumer protection, whilst also ***ensuring the conditions for competition are maintained***.*"*[1] [our emphasis]

The Retail Margin

Continued retail market pressures are leading to significant compression of publicly reported retail margins in most regions. Whilst the regulated price may aim to reflect a sustainable efficient margin for retailers, the reality is that many retailers face a significantly lower retail margin. An efficiently functioning retail market is of benefit to all customers. If the regulated retail margin is set below an efficient return, this will undermine market competition and the benefits of long-term market efficiency. An appropriate retail margin is critical to support retailer viability and investment.

We disagree with the draft decision to reduce the retail operating margin from 5.3 per cent to 5 per cent of the total cost stack. There is no regulatory basis to make this reduction.

The regulatory approach to further reduce the retailer margin without a robust regulatory methodology is not sustainable for the competitive market. Under the draft decision, the VDO would have the lowest regulated retail margin allowance in the NEM. It would be lower than highly concentrated retail markets such as Tasmania and the ACT.

A regulatory methodology that simply cherry picks a lower retail margin, without appropriate regard to an efficient margin needed to sustain a reasonable rate of return in the context of risk faced by retailers, jeopardises the efficient functioning of a competitive market over the long term. It can also potentially impact retailer solvency, creating the risk of cascading failures arising from changes in circumstances that inevitably materialise (despite being difficult to predict).

The retail margin is derived from reference to a regulatory benchmarking approach and an expected returns approach. The benchmarking approach is based on the regulatory allowances for retail margins from other pricing regulators in Australia. These margins are based on historical methodologies that are formulated in the context of the unique pricing objectives within that framework.

Further analysis is then undertaken to determine an expected returns based on

> *"estimate the minimum retail margin required in order to compensate equity investors in a notional electricity retailer for the systematic risk they bear when committing equity capital to the firm."*[2]

The expected returns methodology involves establishing a Weighted Average Cost of Capital (WACC) for a representative retailer, then modelling the likely returns of the representative retailer and exogenous market factors that will impact retailer returns. These modelled outputs are then used to determine the implied systemic risk and therefore determine the efficient retail margin.

There are a number of variables used to estimate each input parameter used to determine the efficient margin. To reflect the various states of the world, three scenarios are modelled: low, base and high. Each reflecting a low to high estimate of key inputs such as the WACC, market volatility, electricity demand volatility.

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[1] ACCC, Inquiry into the National Electricity Market, December 2023 Report, page 72.
[2] Independent Competition and Regulatory Commission, consultant report (Frontier), Retail electricity price investigation 2024-27

In the case of the 2024 Frontier updated analysis[3] this leads to the scenario margin of 4.5% (low), 5.2% (base) and 5.9% (high). Importantly this is not a modelled margin range of 4.5% to 5.9% that reflects an efficient retail margin in all circumstances.

The ESC's assertion that the reduction to the 5% margin is reasonable as it is *"within the range estimated by Frontier Economics"* is flawed. Frontier's analysis would only support this conclusion if there were empirical factors that led to an assessment that the modelled input parameters would likely be between a low and base case scenario. The ESC has not undertaken any analysis to support this conclusion. It appears that relevant factors such as market volatility and electricity demand (GDP) indicate bias to the high scenario rather than the low.

Retailer costs are also growing due to increased regulatory requirements and other necessary costs to provide this essential service. We note the recent Draft DMO determination has acknowledged in detail the increasing costs retailers now face. Many of these costs reflect the heightening service obligations of electricity retailers, particularly in servicing customers in hardship and the treatment of bad and doubtful debt. This further justifies a heightened risk scenario being considered under this framework.

Material change to the WEC methodology

The draft decision proposes to change the data used to derive the representative customer load profile. With sufficient historical data now available, the draft VDO uses import only interval meter data rather than the previously used consumption data that included solar exports.

As noted in the draft decision, the customer load profile change has led to an overall decrease in the WEC. This has occurred despite the material increases in volume weighted cap contract prices across all quarters when compared to 2024-25 VDO volume weighted cap contract prices. Swap contract prices have remained largely stable. It is likely that had the customer load profile inputs remained unchanged, the VDO WEC would have increased rather than decreased. We note that in the case of the CitiPower distribution zone, wholesale costs increased due to the lower volumes of solar exports in this area and therefore the subsequent lesser change to the representative customer load profile. This demonstrates how material this change is on the VDO WEC outcome.

The ESC's decision to move to an import only load profile is a material step change in the VDO methodology. Whilst the decision to move to this customer load profile may be justified, such a significant change needs to be carefully managed.

Best practice pricing regulation is most effectively implemented when the regulatory methodology is transparent and predictable. A stable VDO methodology, such as the WEC component, is vital for the industry to predict how regulated pricing will affect the market and therefore retailers' long-term commercial operations. A sudden change in methodology may therefore lead to unintended negative consequences on the competitive market, particularly if the change is counter to actual cost increases.

These risks can be effectively mitigated if the material change in methodology is phased into the pricing methodology over several pricing decisions. Alternatively, the regulator may undertake extensive industry consultation that is well in advance of the pricing change. In the case of the proposed VDO change to import only customer load profiles, this was only publicly raised four months prior to the draft decision. This has

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[3] Independent Competition and Regulatory Commission, consultant report (Frontier), Retail electricity price investigation 2024-27

occured in the context of a methodology that contemplates retailers seeking to manage their risk by acquiring financial hedge products over the course of 12 months.

AGL recommends that the best approach is to phase this change into the VDO methodology. Constructing the mid-point between the import only load profile and the customer load profile inclusive of solar exports is a simple and transparent approach. This approach is prudent given the underlying increases in wholesale hedging costs and the significant dampening effect on the WEC due to the change in consumption profiles.

Treatment of negative prices at times of solar export

As noted in the draft determination, with the continued deterioration of the wholesale value of solar exports in Victoria, retailers may soon be unable to recover this cost from customers. This is due to the regulatory requirement that the feed-in tariff cannot be set below zero. This issue will be further exacerbated if the social cost of carbon is revoked.

We support the consideration of an additional cost component in the VDO to reflect this emerging cost for retailers. With the regulated floor on retail feed-in tariffs, the negative value of some exported electricity will need to be absorbed by the retailer and therefore spread across all customers. This will require an assessment of the representative retailer's customer solar export volumes to derive a total cost of exports. Like other WEC components this will need to be translated into a $/MWh amount. We note this cost assessment may also need to include network import charges that are only recently emerging through Victorian distribution businesses' revenue reset proposals.

Victoria Energy Upgrades (VEU) program costs

The draft decision proposes to maintain the previous approach in calculating the forecast retailer's cost of the VEU program. This approach includes the calculation of the most recent 12 month trade-weighted average spot prices for Victorian Energy Efficiency Certificates. As highlighted in our submission to the Request for comment paper[4], we remain concerned with potential delivery risks of forward contracted supply in FY25, and more generally sufficient contract liquidity for retailers to meet the program's contract surrender requirement. We therefore remain of the view that the VDO VEEC forecast price should include a weighting of the VEU penalty price in the calculation. This is a known risk in the market that is not reflected in historical market performance. In the context of the proposed changes in methodology resulting in a reduced VDO price, the VDO has a heightened obligation to reflect known risks faced by retailers in the VEEC market. Failure to do this will only further reduce retail margins in real terms.

[4] For AGL's submission to the VDO 2025-26 Request for comment paper – see link: https://www.esc.vic.gov.au/electricity-and-gas/prices-tariffs-and-benchmarks/victorian-default-offer/victorian-default-offer-price-review-2025-26#tabs-container2