11 April 2025

Mr Gerard Brody
Chair
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne Victoria 3000

Email: VDO@esc.vic.gov.au

Dear Mr Brody,

RE: 2025-26 Victorian Default Offer – Draft Decision

Origin Energy (Origin) appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) Draft Decision for the 2025-26 Victorian Default Offer (VDO).

In keeping with the underlying objective, the VDO should be set at a level that allows retailers to recover efficient costs and ensuring that customers are protected from unreasonably high prices. We acknowledge that the ESC faces a challenging task in balancing these VDO objectives.

Origin agrees that managing the impact of higher energy prices and broader cost of living pressures, particularly for low-income households and vulnerable customers should be of the utmost priority. It is also crucial that this is primarily done through targeted programs such as concession schemes, customer hardship frameworks and direct bill subsidies.

With the above in mind, Origin considers there are some aspects of the Draft Decision that are not consistent with the balancing of the VDO objective. It is within this context we have framed our discussion of the various matters raised in the draft decision.

Wholesale Energy Cost (WEC)

We support the continuation of the ESC's approach to calculating the wholesale cost allowance.

Retail Margin

We do not support the proposed reduction in the retail margin from 5.3 per cent to 5 per cent and do not consider that the rationale for this has been made clear.

A retail margin of 5 per cent would represent the lowest across the national energy market (NEM). This is despite already low and decreasing levels of retailer profitability in Victoria when compared to other jurisdictions. We are also concerned about the ambiguity in the treatment of retail costs for this decision and the increase in risk this creates.

We consider the prevalence of reduced retailer profitability and increase cost risk do not support a reduction in the ESC's retail margin to the lowest rate in national market.

Retail Costs

Origin broadly supports the ESC's prior approach in deriving retail costs. However, the limited transparency makes it difficult for us to reconcile the retail cost allowance in 2025-26 VDO with the corresponding allowance in the Default Market Offer (DMO) and with our own cost data submission.

We are concerned about the ambiguity in the treatment of "other retail" costs. These costs have been reported as "other" because they do not fall into the categories in the ESC's cost stack template. Regardless they are legitimate and material. The Draft Decision has not provided an explanation of how these costs were assessed and why they appear to have been excluded.

We therefore request the ESC provide greater clarity on how the "other retail" costs have been assessed.

Network Costs

We support the ESC using AER approved network prices for 2025-26. In the event this is not possible because of timing issues associated with the AER's approval of network prices, the ESC should use the 2025-26 network tariffs submitted by the Victorian networks for approval to the AER and apply a "true-up" to account for any differences between proposed and approved network tariffs in future years.

Environmental Costs

Origin continues to be concerned with the operation of Victorian Energy Upgrade (VEU) program. It is unlikely that the current shortfall in certificate creation will be addressed in the short-term, meaning that retailers will continue to face the real prospect of penalty payments through no fault of their own. We consider the ESC should recognise the structural deficiencies in this scheme and include a tax adjustment to the penalty cap price as part of its weighted average price calculation.

If you wish to discuss any aspect of this submission further, please contact Sean Greenup [redacted]

Yours Sincerely,

[redacted]

Steve Reid
General Manager, Regulatory Policy

1. Wholesale energy cost

[1] We support the continuation of the ESC's approach to calculating the wholesale cost allowance.

[2] We continue to support the market-based approach to forecast the wholesale energy cost, including using a combination of ASX Energy cap and swap trade data to determine a retailer's hedging costs. We also support accounting for PV exports in the load profiles for wholesale forecasting.

2. Retail Operating Margin

[3] In the Final Determination for the 2023-24 VDO, the ESC reduced the retail margin from 5.7 per cent to 5.3 percent. We did not support that decision on the basis it was not validated with market-based data.

[4] For this year's VDO, the ESC is proposing to further reduce the margin to 5.0 per cent.

[5] The key reasons for this reduction is that the ESC has observed there are still median market offers priced below the VDO, (inferring that the VDO includes sufficient buffer), and that the margin is consistent with other jurisdictions and within the range determined by Frontier Economics.[1] However, as we discuss in further detail below, we do not consider that the reasoning set out in the Draft Decision supports the decision to again reduce the margin.

2.1 Market offers and actual margins

[6] In assessing the appropriate margin, it is important to understand the relationship between the retail margin and EBITDA. The retail margin should compensate retailers for the level of risk that they face operating in the defined market; the greater the risk the greater the retail margin that is required for capital invested in the business to earn an appropriate return. EBITDA on the other hand is a measure of a retailer's operating profitability.

[7] The derived EBITDA is a relevant consideration when determining an efficient margin. This is because it reflects the actual margins retailers are achieving across all market offer customers.

[8] Assessing the EBITDA highlights the impact of a VDO decision on retailer profitability and whether the VDO has provided sufficient compensation in terms of both margin and costs. The ESC has determined that retailers' actual, average operating margin in Victoria has reduced from 4.6 per cent in 2023 to about 2.5 per cent in 2024.[2] This compares to a weighted average EBITDA in the DMO jurisdictions of 5.6 per cent.[3]

[9] Despite this fall in profitability, the ESC notes that median market offers are still priced below the VDO. However, it is important to recognise that advertised market offers tend to be lower priced than expired market offers to attract new customers. In some instances, these offers can be loss making. To assess the impact on profitability, a retailer's entire portfolio (as reflected in the EBITDA) should be considered, not just specific offers within that portfolio.

[10] An EBITDA margin of 2.5 per cent does not reflect a sustainable level of profitability and is well below other jurisdictions. The number of active retailers in Victoria has also fallen with 4 retailers exiting the market in 2023-24.[4]

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[1] Frontier, Retail electricity price investigation 2024-27 Report for The Independent Competition and Regulatory Commission, 21 November 2023, p. 62.
[2] ESC, Victorian Default Offer 2025-26: Draft Decision Paper, p. 52.
[3] AER, Default market offer prices 2025–26: Draft determination, p.127.
[4] Australian Competition and Consumer Commission, 'Inquiry into the National Electricity Market', 3 December 2024, p. 63.

[11] A reduction in the retail margin would place further financial pressure on retailers and potentially reducing retailer activity.

1.1 Comparison to other regulators

[12] The ESC considers its proposed margin is within its consultant's (Frontier) recommended range of between 4.8 per cent and 6.1 per cent.

[13] Frontier applies the expected returns approach when recommending a range. The key objective of the expected returns approach is to estimate the minimum retail margin required to compensate equity investors in a notional electricity retailer for the systematic (i.e., non-diversifiable) risk they bear when committing equity capital to the firm.[5] As noted by Frontier, this is not to say that non-systematic (i.e. asset-specific) risks should be ignored altogether by regulators, rather, any relevant asset-specific risks should be addressed through other cost allowances rather than the retail margin.

[14] In running its model, Frontier developed 243 potential scenarios assuming different risk profiles and market conditions. Its estimated range is based on the middle third of the rank-ordered estimated margins to avoid extreme outcomes. In other words, it takes the 33rd and 67th percentiles of its projections.

[15] The proposed margin of 5 per cent sits at the lower end of Frontier's range which is the bottom third of all projections. Such a low margin infers low risk.

[16] However, we contend there is notable risk in the market. Retail profitability is declining from already low levels, there is ambiguity around the assessment of retail costs (see next section) and there have been several retailers exist the market. Despite this, the ESC has proposed a further reduction in the retail margin to the lowest rate in the national market.

[17] On this basis we do not see any evidence to support reducing the retail margin.

Recommendation

- Because of the impact of increased risk from a lower retail cost allowance and the current low levels of retailer profitability we recommend that the ESC retains the retail margin at 5.3%.

3. Retail Costs

[18] In 2023-24, the ESC adopted an approach of using a weighted average of retailers' actual retail operating costs. At the time, this resulted in a reduction of about 10 per cent in the retail cost allowance compared to that under the 2022-23 VDO. Origin supported this change because we considered the use of actual retailer costs to be the most appropriate approach.

[19] We support the ESC continuing to use actual retail operating costs for 2025-26 VDO. However, the limited transparency (particularly as it relates to the treatment of the 'other' cost category) in this decision makes it difficult for us to reconcile the retail cost allowance in the VDO with the corresponding allowance in the DMO and with our own cost data submission.

[20] To highlight this issue, table 1 below sets out a comparison of the ESC's VDO allowance with the AER's DMO allowance. While the total retail cost allowance in the VDO is significantly lower than the DMO, we acknowledge this is largely explained by the difference in approach to calculating

[5] Frontier, Retail electricity price investigation 2024-27 Report for The Independent Competition and Regulatory Commission, 21 November 2023, p. 55.

CARC and the inclusion of smart meter costs in the DMO (i.e. if these were set to zero the CPI adjusted total costs would be very close). We also note that the ESC includes bad debt in its retail operating cost allowance (ROC) whereas the AER report this cost separately. Therefore, the only unexplained difference is the treatment of "other retail costs".

[21] In its current cost assessment, the ESC identifies "other" costs. These are largely wholesale administration related costs such as AEMO costs, ancillary fees, NEM fees and prudential costs. Given their link to wholesale activities the ESC does not include these in the retail cost stack but as a separate individual line item of $19 per customer in the cost stack. This approach is also taken by the AER (i.e. they are not included in retail costs) who derive a similar cost amount for these items.

[22] However, there is an additional "other" cost item within the retail operating cost category that relates specifically to "other retail" costs. These are costs that do not fall into the categories in the ESC's cost stack template and as a result have been reported as "other retail". Regardless of how they have been reported, they are legitimate and material retailer costs. However, the ESC does not appear to have included these costs in its retail cost allowance.

[23] To highlight the magnitude of this exclusion, the highlighted 'Other Retail Costs' row in table 1 shows that the AER allowance for "other retail" costs for retailers operating in NSW is $24.67 per customer; $40.40 per customer in Queensland; and $28.94 per customer in South Australia. The ESC has not included an allowance for Victorian retailers.

[24] We believe it is incumbent on the ESC to clarify how the "other retail" costs have been assessed and why they have been excluded from the cost stack, especially when the AER has included the same costs for the same retailers in their DMO decision.

Table 1: Comparison of ESC with AER DMO residential retail costs per customer ($ exc GST)

Cost Component	ESC	AER Ausgrid	AER Endeavour	AER Essential	AER Energex	AER SAPN
ROC	146.11	101.84	101.84	101.84	104.28	98.39
CARC	46.14	66.19	66.19	66.19	54.95	61.85
Bad Debt	0.00	38.30	38.30	38.30	36.40	39.94
Smart Meter	0.00	43.21	68.67	63.89	57.52	59.66
Other Retail Costs	0.00	24.67	24.67	24.67	40.40	28.94
CPI Adj	0.00	15.57	17.01	16.74	16.67	16.39
Total	**192.25**	**289.78**	**316.68**	**311.63**	**310.23**	**305.17**

Source: Origin analysis of AER data contained in the AER Draft decision DMO 2025-26 and the AER cost assessment model

Recommendation

- We seek an explanation from the ESC for why it has not included "other retail" costs in its cost stack.

4. Network Costs

[25] We support the ESC using AER approved network prices for 2025-26. In the event this is not possible because of timing issues associated with the AER's approval of network prices, the ESC should use the 2025-26 network tariffs submitted by the Victorian networks for approval to the AER and apply a "true-up" to account for any differences between proposed and approved network tariffs in future years.

Recommendations

- Support the use of final approved network prices. Where this is not possible, the ESC should use the network tariffs contained in the network pricing proposals submitted for approval by 21 May 2025.

5. Environmental Costs

[26] As discussed in previous submissions, the VEU program continues to experience unforeseen supply side disruption. These issues were not anticipated when the ESC developed its cost-recovery method.

[27] There has been a shortfall in the supply of Victorian energy efficiency certificates (VEECs) relative to prescribed targets since mid-2022, driven by the removal of some of the more significant certificate creating activities related to refrigerated cabinets and commercial lighting. In 2023 and 2024 only 4.8 and 5.3 million VEECs were created compared to the legislated target of 7.1 and 6.9 million respectively.[6] Notably, VEEC creation in 2023 was 44 per cent below 2022 levels, highlighting the correlation with the change in eligible activities.[7] The tight supply / demand dynamic has driven VEEC prices toward the tax-adjusted penalty price.

[28] Consistent with our previous submission, we consider that the shortage in certificates significantly increases the risk that retailers will not be able to acquire sufficient certificates to meet their obligations and therefore face penalty cap prices. Given the penalty cap is not tax deductible, retailers face potential financial loss through no fault of their own.

[29] While we acknowledge that the Department of Energy, Environment and Climate Action is currently conducting a review of the VEU program, it is unlikely that certificate supply shortages will be significantly addressed in the short-term.

[30] To avoid retailers being exposed to financial risk outside of their control, we maintain the view that the ESC should include a tax adjustment to the penalty cap price as part of its weighted average price calculation.

Recommendation

- To avoid retailers being exposed to financial risk outside of their control, we maintain the view that the ESC should include a tax adjustment to the penalty cap price as part of its weighted average price calculation.

[6] Victorian Energy Upgrades Dashboard Victorian Energy Upgrades data dashboard | Essential Services Commission
[7] Ibid, Origin analysis.