19 December 2024

Ms 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 – Request for comments paper

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

Origin strongly supports the ESC's decision to apply a consistent method to calculate the VDO for 2025-26. A stable regulatory framework contributes to a well-functioning retail market and provides retailers with certainty so that they can appropriately manage their financial risks.

We retain our position that the previous retail margin of 5.7 per cent facilitated new entry and robust price competition. With no indication that the level of risks faced by retailers has diminished, if the retail margin is to be reviewed, the starting position should be that at a minimum the current level is retained.

Where retailers are forced to pay penalty caps due to a shortfall in Victorian energy efficiency certificate (VEEC) creation, we propose that the ESC include a tax adjustment to the penalty cap price as part of its Victorian Energy Upgrade (VEU) price calculation.

We support continuation of the ESC's approach to the wholesale cost allowance but encourage the ESC to undertake an assessment of the performance of the model over time using actual spot price / demand data.

Additional commentary on these and other matters contained in the ESC's paper are provided below.

Retail Margin

The retail margin should reflect the level of risk that a retailer faces; the greater the risk the greater the retail margin that is required in order that capital invested in the business earns an appropriate return.

We retain our position that the rationale for the ESC to reduce the margin from 5.7 per cent to 5.3 per cent remains unclear. The previous margin of 5.7 per cent facilitated new entry and robust price competition to the benefit of consumers. Furthermore, previous ESC analysis indicates that since 2017-18 there has been a steady reduction in profit margins of retailers operating in Victoria, with earning dropping by as much as 40.4 per cent per customer.[1] These historically low margins reinforce that retailers have not been making excessive profits.

[1] Origin analysis using Figure 9, ESC, 'Victorian Default Offer 2023-24 Final Decision', p. 53.

If the margin is reviewed an evidence-based approach should be adopted if any adjustments are made. This should include an examination of the trend in margins, active retailers and the distribution of market share.

We note the ESC has previously cross-checked the expected returns against the range of retail margins set by Australian regulators in their latest regulatory decisions. However, this requires caution because these rates are not directly comparable. The ESC has previously highlighted the regulated returns set by the Independent Competition and Regulatory Commission (ICRC) and the Office of the Tasmanian Economic Regulator (OTTER). However, the Australian Capital Territory and Tasmania have lower risk profiles due to relatively lower levels of bad and doubtful debt[2] and wholesale electricity price risks respectively.[3] Therefore their retail margins are not directly comparable to other NEM jurisdictions.

We also consider that the risks of being a retailer in Victoria have not diminished since the last VDO decision. Against this background and the trend of growing risks for retailers, in the interest of promoting regulatory certainty and encouraging investment, we believe it is important that existing margins are maintained.

Retail Costs

We support the ESC applying a consistent approach with the AER to determine the retail operating cost allowance. Using the same source of data will provide consistency and certainty and will reduce costs on retailers to produce this information. In this regard we support the separation of residential and small business costs.

Victorian Energy Efficiency Certificate prices

Under the current ESC approach, the VEU costs are derived by multiplying the 12-month trade-weighted average spot price for VEECs by the greenhouse gas reduction rate.

As we have highlighted in previous submissions, the VEU scheme continues to experience supply side disruption. The prescribed activities which create VEECs have changed over time, and this is leading to a market wide shortfall as certificates become harder and harder to create. If this deficit in certificate creation continues retailers will be unable to procure the required amount of VEECs resulting in them paying a significantly higher proportion of penalty cap certificates.

These issues were not anticipated when the ESC developed its cost-recovery method and as a result retailers will potentially be exposed to financial losses unless the ESC modifies its approach.

The problem with the current method is that it does not factor in the tax implications to retailers of having to pay the penalty cap. When a retailer acquires and surrenders a VEEC, it is tax deductible whereas the penalty cap is not.

In the current environment, retailers have no choice but to pay the penalty cap because of the shortfall in certificates.

To address this inferred financial penalty, we propose that until such time as the deficiencies in the scheme are addressed, the ESC should include a tax adjustment to the penalty cap price as part of its weighted average price calculation. This adjustment would only apply where retailers are forced to pay the penalty cap due to a shortfall in the supply of certificates.

We believe this will ensure that retailers do not bear an unnecessary risk because of shortcoming in the existing VEU scheme.

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[2] ICRC, 'Draft Report, Electricity Pricing Investigation 2020-24', February 2020, p. 43.
[3] OTTER, '2022 Standing Offer Electricity Pricing Investigation Final Report', April 2022, p. 41.

Wholesale Energy Cost

The ESC intends to continue with its current approach to exclude solar exports when estimating the load profile.

The ESC notes that the AER has excluded customer exports from their load profile. However, the AER approach is predicated on retailers being free to set their respective FiTs independent of the DMO process.[4] This is not the case in Victoria where a regulated minimum FiT applies. We consider that the ESC should detail how the model addresses the circumstance where a regulated FiT would not result in the lower import price plus the cost incurred by paying out the FiT for the exports does not equal the revenue earned by supplying the net profile at the higher net import price and not paying a FiT.

In addition, as raised previously, we consider that wholesale spot price modelling should ultimately reflect the range of potential scenarios a retailer could be exposed to. For this reason, we consider that the ESC should undertake an assessment of the performance of its model over time using actual spot price / demand data. This should include assessing whether actual spot price outcomes fall within the range of modelled prices, and deriving an updated WEC using actual spot price / demand data for comparison with the modelled WEC applied for each VDO period.

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

Yours Sincerely,

[redacted]

Steve Reid
General Manager, Regulatory Policy

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[4] ACIL Allen,