5 April 2019

Essential Services Commission
Level 37
2 Lonsdale St
Melbourne Victoria 3000

Lodged electronically: RetailEnergyReview@esc.vic.gov.au

Dear Commissioners

Victorian Default Offer to apply from 1 July 2019 – Draft Advice – 8 March 2018

EnergyAustralia is one of Australia's largest energy companies with around 2.6 million electricity and gas accounts across eastern Australia. We also own, operate and contract an energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 4,500MW of generation.

The Victorian Default Offer (VDO) is intended to provide "a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the retail electricity market, without impeding the consumer benefits experienced by those who are active in the market".[1] In line with its terms of reference, the Commission sought to recommend a price cap, replacing standing offer tariffs, that reflects efficient costs. We consider the draft VDO does not reflect the realistic efficient costs of providing retail services. While the VDO will reduce prices for customers on standing offer tariffs, it creates a risk of retailer exit, with associated customer disruption, decline in product innovation and possible reductions in service quality as remaining retailers cut costs to maintain a positive retail position. This will disadvantage the majority of customers engaged in the market and future VDO customers alike.

As we stated in our prior submission, the Commission should advise how the VDO will impact on competition when making its final recommendation to the Minister, in accordance with its legislative obligations. These considerations should also explicitly guide the Commission's decisions in relation to the VDO under its terms of reference.

Our detailed response to the Commission's draft VDO recommendation is attached. We consider the draft recommended VDO is below efficient costs and have identified several issues for the Commission's consideration, particularly in estimating retailer operating costs. We also recommend the Commission immediately commence consultation on a more transparent method of estimating wholesale costs for its next VDO determination. If you would like to discuss this submission, please contact Lawrence Irlam on [redacted] or [redacted]

Regards

Sarah Ogilvie
Industry Regulation Leader

[1] https://www.esc.vic.gov.au/sites/default/files/documents/retatil-market-review-victorian-default-offer-terms-of-reference-20181221.pdf

The ESC's final recommendation to the Minister should assess market impacts

We refer the Commission to our previous submission and objections to setting a price cap that is in line with efficient costs. We accept this is a decision of the Victorian Government.

It is not clear from the Government's terms of reference whether the Commission is required to recommend a VDO that preserves the benefits of competition. Regardless of its terms of reference, we consider that the Commission is required to consider the market impact of the VDO under its legislative obligations when making its recommendations to the Minister.

Specifically, sections 8 and 8A the Essential Services Commission Act 2001 require the Commission to have regard to various matters in performing its functions, such as the degree and scope for competition within the industry.

The Commission's draft VDO, by setting a 'fairer' price in line with efficient costs, would promote the interest of consumers by preventing inefficient prices that have materialised because of ineffective competition. This is the 'safeguard' aspect of the Government's VDO. However, the VDO's other design feature, to not impede the benefits for engaged customers, is likely in conflict with the Government's instruction to set the VDO in line with efficient costs.

The Commission notes its terms of reference require it to have regard to its statutory objectives, the Thwaites Review and other matters it considers relevant.[2] The Commission also lists the matters it must have regard to under section 8A of the ESC Act. The Commission states that the Government's terms of reference provide guidance on the application of its statutory objective. These observations lead into a discussion of the VDO's 'fair' price in the context of efficiency, including the exclusion of competitive allocation (referred to as 'headroom') and other elements of the cost stack.

Beyond this, Commission appears to presume that the matters it must consider under legislation have already been factored into the Government's terms of reference. For example:[3]

> *…we note that the background section of our terms of reference states that the VDO will be made available to customers "without impeding the consumer benefits experienced by those who are active in the market." We understand this statement to be an articulation of policy intent — that is, that the VDO is not intended to be a single, mandatory price to the exclusion of all others. Retailers will not be prohibited from making other offers available to customers, leaving customers free to enter these alternative contracts if they represent good value for money (even if they cost more than the VDO).*
>
> *On this basis, we have interpreted the reference to not impeding customers who are active in the market as a statement of policy design rather than a factor which we must take into account when developing a pricing methodology.*

[2] Essential Services Commission, *Victorian Default Offer to apply from 1 July 2019 — Draft advice*, 8 March 2019, p. 10.
[3] ibid, p. 12.

Elsewhere, the Commission notes that retailers will be able to make market offers that are above or below the VDO, and that this is consistent with its statutory objective under section 10(b) of the Electricity Industry Act 2000, relating to promoting the development of full retail competition.[4] The Commission's consideration of market impacts is limited to the preface of its draft advice, where it suggests customers will be drawn towards the 'fair' VDO price, resulting in a convergence of market offers:

> *It's worth thinking about what a highly efficient retail electricity market might look like. If customers are highly engaged, they would not tolerate prices that were not cost reflective. They would switch away from any retailer who tried to raise prices above the efficient cost of providing the service to them. As a result, prices across the entire market would converge on the efficient cost of providing electricity services. There would be no headroom in prices and no cross-subsidies between different groups of customers.*
>
> *We believe this is the "fair" price that the VDO is intended to make available to customers.*

Our expectation is also that the VDO will result in price convergence. The Commission would be aware of analysis undertaken by the Australian Energy Market Commission, reflecting on the UK experience, involving a reduction of benefits for customers who previously engaged in the market while delivering benefits for those who did (or do not).[5] We encourage the Commission to elaborate on the likelihood of price convergence under the VDO and loss of benefits to engaged customers from possible price increases. Our view is that the VDO will also significantly dull competition and the long-term interests of customers will be negatively affected by having less innovative offers in the market, as well as disruption via possible exit of retailers.

In addition to explicitly assessing how the VDO will affect the degree of scope of competition[6] (for example, how the VDO addresses any lack of competition or would improve it), the Commission should also address the related matter of the benefits and costs of regulation (including externalities and the gains from competition and efficiency).[7] That is, it should consider the joint impact of Government requests rather than in isolation.[8] Imposing an efficient price on the market (or below an efficient price, as we believe the draft VDO to be) will significantly reduce the expected benefits to customers of requiring retailers to inform them of best offers on their bills, comparing market offers to the VDO when advertising and new comparison tools in energy fact sheets.

More broadly, the Commission should not limit itself to the Government's terms of reference and should explicitly address all the relevant matters listed in section 8A of the Essential Services Commission Act. The Government's decision to implement the VDO leaves the Commission to determine various design features which warrant scrutiny under a number of these matters. Similarly, the Commission, as an independent agency, has an important role to play in advising Ministers on the expected impact of their decisions. These matters are listed by the Commission as the "broader context" for its

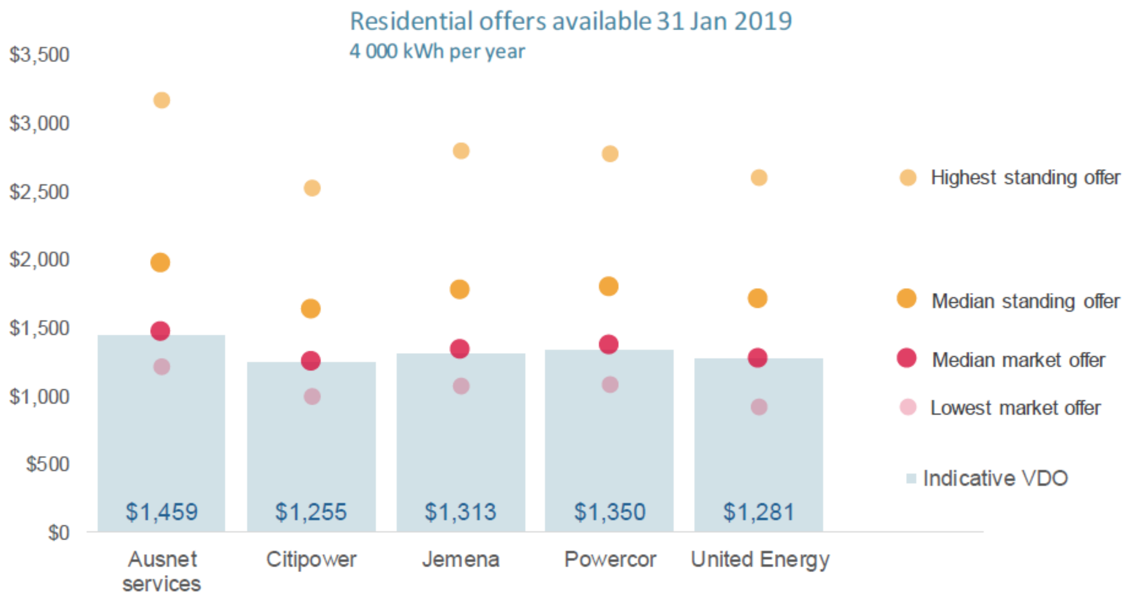
---

[4] ibid, pp. 8, 13
[5] https://www.aemc.gov.au/market-reviews-advice/advice-coag-energy-council-default-offer
[6] Essential Services Commission Act 2001, s. 8A(c).
[7] Essential Services Commission Act 2001, s. 8A(e).
[8] Essential Services Commission, 2019, p. 13.

work, and are of high interest to stakeholders, but have not yet been adequately addressed.[9]

The VDO is lower than efficient costs by comparison to market offers

We are encouraged that the Commission has adopted our suggestion to compare its draft VDO against market offers. Such a comparison may provide a useful cross-check on the VDO amount given the uncertainties in developing various costs estimates with limited data and under time pressures. The analysis in the Commission's draft report suggests the VDO would result in the average customer coincidentally paying approximately the same as the median market offer. For example:



Source: Essential Services Commission

The Commission made no written statements regarding what this comparison means in terms of its recommended VDO. However, this comparison implies that the median market offer corroborates the VDO's reflection of efficient costs. This comparison also suggests that the VDO benefits retailers by being above half of all offers in the market as well as being above the lowest market offer.

The practice of conditional discounting is problematic and we accept moves to make such discounts reflective of costs. However, we understand that the market offers used in this comparison assume all conditional discounts are met. This is not the case. The ACCC has indicated these discounts can currently equate to as high as $859 for an annual residential bill in Victoria[10], and 27% of all residential customers do not achieve their conditional discount.[11] The actual value of market offers to customers and retailers i.e.

[9] ibid, pp. 10-11.

[10] ACCC, *Monitoring of supply in the National Electricity Market — March 2019 Report*, p. 18.

[11] ACCC, *Restoring electricity affordability and Australia's competitive advantage - Retail Electricity Pricing Inquiry—Final Report*, June 2018, p. 264

expected average bill payment per customer, is therefore likely to be materially above the values plotted by the Commission. To the extent the annual bill from the median and lowest market offers are used as a proxy for efficient costs, the Commission's comparisons, once discounting is accounted for, will indicate that the VDO is lower than the majority of market offers and somewhat less than efficient costs. This general conclusion is supported by our analysis of specific items of the cost stack.

The Commission should consider more transparent wholesale cost methods

Our high-level comparison indicates a relatively small but material divergence between Frontier's wholesale cost estimation and our own wholesale costs. While the Commission has published information on Frontier's estimates, we have been unable to identify why this difference arises. We remain concerned that Frontier's wholesale cost estimation could materially understate prudent and efficient wholesale costs, and leave retailers exposed to higher levels of risk that they may not tolerate.

We appreciate the Commission is time-limited and therefore heavily reliant on Frontier's method for its final recommended VDO. We expect the Commission to shortly commence consultation on improvements to estimation methods across the entire cost stack. As part of this, we will encourage the Commission to adopt a more transparent wholesale cost method, including one that explicitly examines 'shaping' costs (e.g. as presented recently by Globird Energy[12]). If the variety of 'shaping' costs (i.e. the variance in the "peakiness" of a customer's consumption) is not factored into the VDO's wholesale cost component, retailers will not recover their full costs and be discouraged from serving customers with load profiles that impose greater costs than those imputed into the benchmark allowance.

Regardless of the Commission's methods to determining the wholesale cost component, wholesale costs for 2020 are presently forecast to increase, presenting a risk that customers encouraged to move onto the VDO from 1 July could see prices rise from 1 January 2020. The Commission would be aware of retail price caps in the UK being increased recently after only a few months of being in place, with the regulator having to explain to customers why a 'capped' price is increasing.[13]

In implementing the VDO, the Minister and the Commission are now acting in the place of retailers who manage reputational and commercial risk by typically limiting price changes to once a year, and also by offering products that fix prices over longer periods e.g. our Secure Saver product fixes prices for 2 years. In other regulatory settings e.g. determinations for monopoly water and electricity network service providers, consumers are protected from price volatility by smoothing or carrying over cost items from year to year, and the Commission may wish to consider price changes in future years in making its final VDO recommendation. At the very least the Commission should present an analysis of cost trends and likely price impacts for the Minister's consideration.

Environmental costs should accommodate contracting for LGCs

Frontier's wholesale cost method assumes retailers minimise risk through an optimisation of contracting positions. In the case of liabilities under the Large-scale

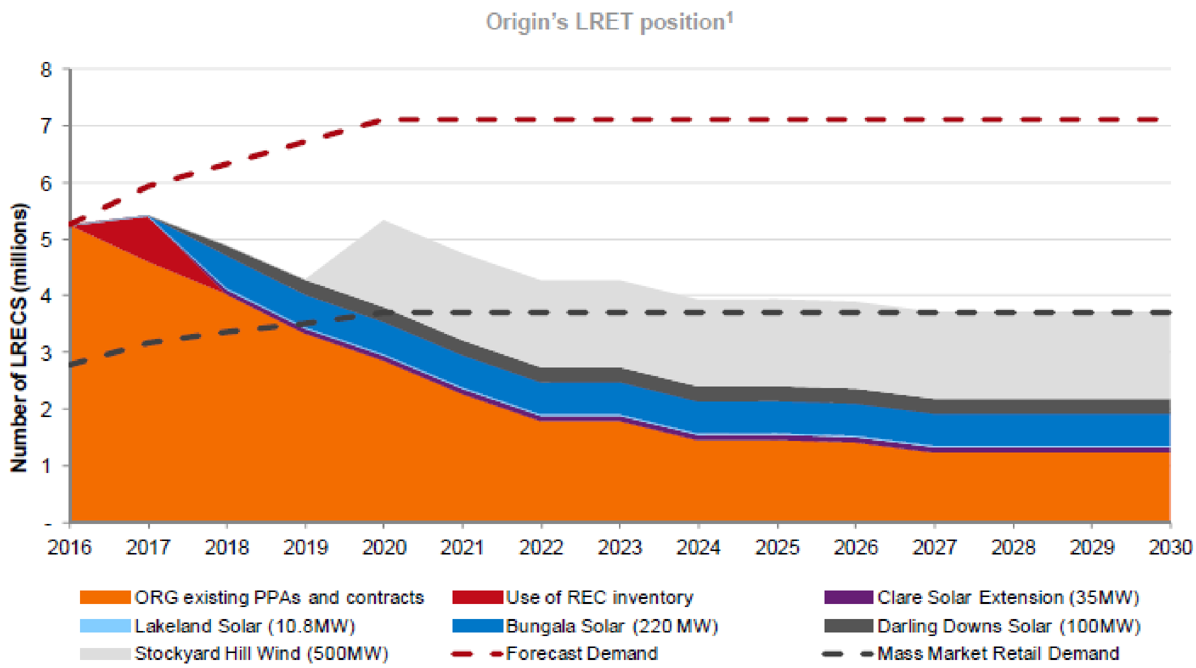
[12] https://www.esc.vic.gov.au/sites/default/files/documents/VDO%20-%20Draft%20advice%20-%20public%20forum%20presentation%20-%20GloBird%20Energy%20-%2020190325.pdf

[13] https://www.bbc.com/news/business-47133564

Renewable Energy Target (LRET) and Small-scale Renewable Energy Scheme (SRES), however, Frontier and the Commission assume that the prudent or average retailer is entirely exposed to spot markets.

The Commission appears to have adopted its preferred market approach for LRET costs in the absence of information on power purchase agreements (PPAs) rather than through an examination of retailer positions. For example, it notes that PPAs are often confidential, yet it asserts that information from PPAs may not be representative of the wider industry.[14]

As outlined in our prior submission, the Commission's approach materially understates what we would regard as efficient costs for meeting LRET liabilities. This will worsen as the price of large-scale generation certificates (LGCs) is expected to continue to decline. This point was made in AGL's submission[15] to the Commission's staff working paper and appears to have been overlooked by the Commission in listing stakeholder concerns.[16] Public information prepared by Origin indicates that the majority of its LGCs are currently sourced from PPAs (and entirely in the case of mass market customers).[17] We appreciate a market approach is more transparent but encourage the Commission to seek further information from retailers on the extent to which a market approach understates their LRET costs.



Source: Origin Energy

[14] Essential Services Commission, 2019, p. 33.
[15] https://www.esc.vic.gov.au/sites/default/files/documents/VDO-staff-paper-submission-agl-20190131_R.pdf, p. 5.
[16] Essential Services Commission, 2019, pp. 32-3.
[17] https://www.originenergy.com.au/content/dam/origin/about/investors-media/documents/Half%20Year%20Results%20Presentation.pdf

The Commission should set a higher retail operating cost allowance

We recommend the Commission reconsider placing primary weight on the ACCC's retail costs reported in its Retail Electricity Pricing Inquiry (REPI) final report, and further examine how prior regulatory benchmarks were constructed.

Our view is that there appears to be a mismatch between the cost allowances constructed by regulators and what was reported by the ACCC. We are concerned the Commission has taken these different sources to be reported on the same basis, and differences in values are explained by cost reductions over time, driven by the benefits of retail competition.[18]

We expect retailers took all necessary steps to submit accurate and complete data to the ACCC as part of the REPI. When viewed in full, the ACCC's dataset would provide a rich resource for the Commission in examining retailer costs. However, we have some concerns that the Commission considers the summary values in the ACCC's report to be preferable, to the exclusion of other sources of information, on the basis of it being more recent. Frontier also comment that the ACCC "had access to data from 18 retailers over a number of years, which it examined and 'cleaned' for inconsistencies or potential errors."[19] This has no bearing whether the data in the ACCC's report are compatible with the Commission's cost stack.

Our primary concern is that reported costs from the ACCC appear to exclude shared costs. In its submission to the Commission's staff working paper, AGL stated that its annually reported cost to serve excludes shared costs, and once accounted for, these costs are more aligned with regulatory benchmarks.[20] We note that AGL's reported cost to serve (e.g. $83 per customer) aligns with the average tier three retailer costs calculated by the ACCC and reproduced in the Commission's report.[21] Origin's reported costs of around $120 per customer, as examined by Frontier[22], are almost double the tier one average reported by the ACCC, which also suggests to us the ACCC has not included Origin's shared costs.

Our expectation is that issues around cost allocation, noted in several places by the Commission and Frontier, would have been accounted for in regulatory decisions. For example, IPART obtained cost data from retailers and discussed with them what items were included and excluded, as well as compared this to data reported by listed companies.[23]

We recognise that there is some circularity in continuing regulatory precedent but consider the Commission has had insufficient time and data (including visibility of the ACCC's dataset) to improve on this. Elsewhere the Commission has adopted a retail margin in line with recent regulatory decisions and we consider this to be a prudent approach for this first recommended VDO.

The Commission's five percent increase to the ACCC's reported average operating costs for Victoria would better align its allowance to what we would regard as efficient costs. However, this adjustment appears to reflect the Commission's concern that the ACCC's

[18] Essential Services Commission, 2019, p. 48.
[19] Frontier Economics, *Retail Costs and margin – a report for the Essential Services Commission*, February 2019, p. 16.
[20] https://www.esc.vic.gov.au/sites/default/files/documents/VDO-staff-paper-submission-agl-20190131_R.pdf pp. 5-6.
[21] Essential Services Commission, 2019, p. 43.
[22] Frontier Economics, 2019, p. 11.
[23] IPART, *Review of regulated retail prices and charges for electricity from 1 July 2013 to 30 June 2016 — Electricity — Final Report*, June 2013, pp. 99-104.

average cost understates that of smaller retailers. The Commission's explicit justification is that "in an efficiently operating market it would be unreasonable to assume that the marginal customer would be serviced by a retailer with costs notably higher than the average" and the adjustment "recognises that the marginal retailer servicing the marginal customer in a more efficient market, is likely to be nearer the average retailer."[24] The Commission has not, when determining each item of the cost stack, taken a systematic approach to defining whether the VDO is intended to reflect the costs of serving the marginal customer, nor has it explicitly constructed the notional benchmark retailer as foreshadowed in the staff working paper.[25] Accordingly, this five percent adjustment appears arbitrary and we support its removal for the final recommended VDO. The need to make such an adjustment stems from the Commission's inability to reconcile elements of the ACCC's report, which we hope will be resolved by adopting prior regulatory benchmarks for its final recommended VDO.

The Commission should clarify what its retail margins cover

The Commission has recognised that risk may be compensated in cost items or the retail margin, however as noted above, the Commission should clarify whether the margin is intended to compensate retailers for depreciation (as well as tax and interest costs). For example, the Commission refers to the ACCC's measure of earnings before interest, tax, depreciation and amortisation (EBITDA), and ultimately relies on regulatory EBITDA margins, however uses Frontier's measures as an acceptable range, which are earnings before interest and tax (EBIT) only.

The Commission should also confirm that its 5.7% retail margin is not intended to be a transitional margin that reduces over time, as flagged in its staff working paper and on which stakeholders provided various feedback.[26] Our presumption is that the Commission will consult on and undertake a fulsome analysis of margins and compensable risks of retailers operating in Victoria for future VDO determinations.

On a minor note, we consider that Frontier's analysis is based on a limited sensitivity of WACC values, reflecting inputs determined by the Commission. We expect that using a wider range of WACC parameters is unlikely to affect the Commission's decision to rely on recent regulatory determinations, as it would only serve to widen Frontier's range of outcomes. We also note that Frontier's range of WACC values in its expected returns analysis (i.e. around 100 basis points between highest and lowest WACC) has a negligible impact on its EBIT margins, which on face value seems implausible and could be explained further.

Other issues in the Commission's approach to setting the VDO

We also note the following relatively minor issues for the Commission's attention:

- Marginal loss factors – we note the Commission is using published AEMO values. However, when marginal loss factors are combined with distribution loss factors,

[24] Essential Services Commission, 2019, p. 48.
[25] Essential Services Commission, *Victorian Default Offer for domestic and small business electricity customers — Staff working paper*, December 2018, p. 6.
[26] Essential Services Commission, 2019, pp. 55-7.

this results in Ausnet's combined loss factor being below Citipower's, which we consider is a perverse result Ausnet's larger, predominantly rural network area.

- The Commission's network cost calculations do not include the premium feed-in-tariff pass-through charged by United Energy (i.e. a fixed charge of 5.32 cents per day[27] or around $19 per customer per year). United Energy is the only distribution business to list these charges separately in their network tariff schedule (other distribution businesses include this in their network use of system charges), which may be why it was overlooked by the Commission.

- The Commission should have careful regard to how its allocation of benchmark fixed and shared costs results in prices per tariff component that diverge from current standing offer tariffs. Some of the daily charges under the draft VDO may be higher than what customers currently pay, potentially disadvantaging smaller users. Rectifying this would require some judgement in rebalancing tariffs away from the Commission's cost allocation approach and so difficult to justify, however it (and the Minister) should be mindful of these potential impacts when implementing the VDO.

Network tariff reassignment

The Commission noted the potential risk to retailers of being compelled to offer customers a flat tariff VDO while still paying distributors network costs on the basis of different tariff structures. The Commission was "not aware of any barrier to the retailer passing on tariff reassignment costs that are levied by the network business" and it will "monitor how distribution businesses cooperate with retailer request for network tariff reassignments prompted by customers requesting the VDO."[28]

The Commission should clarify its comments regarding passing on reassignment costs and how this would occur under the VDO without any allowance in the cost stack. We expect the Commission is referring to administrative costs, not those arising from any mismatch between (flat) retail tariffs and (non-flat) distribution tariffs.

We remain concerned that there is no requirement on distributors to move customers onto a particular tariff to accommodate retail price regulation. We are encouraged that the Commission will monitor tariff reassignments and we will explore avenues to address any problems that arise, if they cannot be addressed by the Commission under the VDO Pricing Order or related legislation.

The impact of the VDO needs to be carefully communicated

The re-imposition of price regulation is coming at a time where there is a heightened concern around energy prices, a distrust of energy providers and government promises in energy. In this environment, there is a need to carefully communicate the intended impact and scope of the VDO. Customers are likely to be confused by the shift in product offerings caused by the VDO and will demand an explanation. We encourage the Commission to work with the Victorian Government and with retailers in drafting any

[27] https://www.unitedenergy.com.au/wp-content/uploads/2018/12/2019-UE-Schedule-of-charges.pdf see page 25.
[28] Essential Services Commission, 2019, pp. 63-4.

public announcements to assist with managing customer expectations. This will also allow retailers to more effectively prepare for customers seeking further information on the VDO.

The Government intends for the VDO to be widely available to customers. Our primary concern is that the VDO will be promoted as a 'fair' and 'efficient' price. As noted at the outset, we consider that discouraging customers from engaging in the market will be to their detriment over the longer term.

If implemented in its current form, the draft VDO would have significant price impacts on the market. While the price impact for current standing offer customers will be known, price changes for market offer customers are also likely to be materially affected, but different from reductions under the VDO. Announcements are typically made in the form of bill reductions for average sized customers, with the complication that customers will experience different bill reductions in their own circumstances.

The expected reduction in standing offers prices, without necessarily affecting prices paid by market offer customers, reduces the value of any discounts when expressed relative to standing offers. This apparent loss of benefit will cause customer dissatisfaction and is a real cost for us in managing customer expectations. This will be further exacerbated by the notable differences in tariffs set between distribution zones, where customers may become frustrated they are paying more for electricity than others in the state.

Finally, announcements by the Commission regarding the scope and extent of price reductions should be mindful of customers (including our own) that have already benefited from price reductions from 1 January 2019. Customers in embedded networks should also be considered and we are pleased the Commission is already aware of this.[29] Larger commercial and industrial customers that are out of scope should also be explicitly mentioned, including multi-site customers.

There are many matters yet to be resolved

There are still a range of critical issues associated with the VDO implementation that are unresolved. We have been liaising with the Victorian Government to anticipate these changes and expect the VDO's Pricing Order, which will be released for consultation sometime in April, to provide full clarity on matters such as discounting, treatment of time of use customers and other issues usefully identified by the Commission.[30] The timing for consultation and implementation of this Order (expected sometime in May) creates considerable time pressures to implement and comply with VDO requirements alongside other reforms of which the Commission is well aware.

[29] ibid, p. 79.
[30] ibid, pp. 80-82.