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Victorian Default Offer price review 2021

The Australian Energy Council (the '***AEC'***) welcomes the opportunity to make a submission to the Essential Services Commission (the '***ESC'***) on its *Victorian Default Offer price review 2021 Draft Decision* (the '**Draft Decision'**).

The AEC is the industry body representing 21 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

The AEC considers the draft decision does not reflect a maturing methodology in setting a VDO designed to operate in conjunction with a functioning and effective competitive market. The Draft Decision reiterates previous decisions of the ESC, yet fails to consider genuine and efficient risks expected to impact retailers in the next 12 months, to the detriment of engaged consumers. The AEC remains concerned that the ESC is prioritising setting a low VDO, over ensuring that retailers are able to predictably recover efficient costs in a changing regulatory and economic environment.

High level concerns

The Victorian Government has made clear over a number of years that the VDO is intended to represent a simple, trusted, and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity market in Victoria.[1] While the approach to setting the price is left open by the Government, the AEC does not consider the ESC's current approach to setting the VDO aligns with its long-term objective.

At a high level, the ESC appears to be setting the VDO using principles used by regulators to set monopoly prices. Whilst 'productivity factors' might be relevant and necessary in monopoly price setting, in a competitive market where retailers are unable to ensure their individual costs are recovered, nor that their customer base is guaranteed, they have little value on their own in the VDO methodology. The AEC welcome the draft decision of the ESC to opt not to seek to implement a productivity factor in 2021, but are concerned with language in the Draft Decision that appears to suggest retailers should be appreciative of this fact as some form of offset for not delivering an allowance for expected but unknown costs arising from the COVID-19 pandemic and the resulting deep economic recession in Victoria.

Similarly, the AEC is concerned by the ESC's failure to develop predictable and efficient mechanisms to ensure retailers are able to recover capital costs resulting from regulatory change. It appears to the AEC that the

[1] http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S208.pdf

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ESC's approach is to require retailers to effectively prove collectively that costs are efficient, and only then will any consideration be given to including an allowance for that unavoidable impost in the VDO. Whilst this approach might be acceptable in a fast turnaround VDO as seen in 2019 and 2020, the AEC is disappointed not to see any evolution of methodology in the 2021 VDO where the ESC has had a full year to further enhance its approach. The AEC understands from discussions with ESC staff that the Draft Decision would require retailers to prove the costs of implementing regulatory reforms before there would be a consideration of whether or not an allowance should be provided prospectively in the VDO. It has been described as an approach akin to that taken in other regulated industries, such as water. The AEC contends that competitive retail, in particular, the approach to price the VDO based off an undefined 'efficient' retailer, makes mirroring the approach in the water sector for CAPEX costs unsuitable.

Setting the VDO period

The AEC does not support the ESC's draft decision to set a 12 month VDO, albeit with a network price change event occurring on or around 1 July 2021. Retailers face regulatory burdens from price changes, but also face risks from setting the VDO out of alignment with the date input costs change.

However, the AEC accepts advice from the ESC that 2021/22 network costs will not be known by the date it would be required to set the VDO for it to be implemented on 1 July 2021. In this instance, the AEC would support an out of alignment VDO change as soon as possible after 1 July 2021, before the next change on 1 July 2022. This would ensure that as soon as possible, the VDO would be back in alignment with the date of network changes.

The AEC is open to other practicable dates as close as possible to 1 July 2021 that would allow the ESC to undertake a full VDO calculation. This might be 1 August 2021, 1 September 2021, or even 1 October 2021. This would then allow the next VDO period to go up to 30 June 2022, and minimise future regulatory burden that might arise from multiple VDO changes.

Under the Draft Decision, it appears the ESC intends to avoid the challenges caused by network pricing timing in 2021 by merely delaying a decision to re-align the VDO with input cost change dates until the 2022 consultation. The AEC strongly opposes a 12 month VDO, followed by an 18 month VDO from January 2022. This would effectively result in two encumbered VDO calculations, albeit with six monthly customer price changes, and the additional risks for retailers of setting the VDO out of alignment with input costs in the case of the 2021 VDO, and for a longer than standard regulatory period from 1 January 2022 to 30 June 2023.

Retail Operating Costs

The AEC has noted in previous submissions concerns regarding the continued use of historical benchmarks set by the ICRC as a proxy for retail costs in the Victorian market. In the Draft Decision, the benchmarks are retained, with no additional allowance for the impact of the COVID-19 pandemic, the implementation of five-minute settlements (5MS).

Implementing Five minute settlements and regulatory reform CAPEX

In its submission to the Consultation Paper, the AEC provided advice that the implementation of 5MS would cost the industry somewhere at least $250m, and likely more, to implement. The Draft Decision highlights that no evidence was provided to illustrate the percentage of those costs to industry that could be attributed to retailers, and as such, no allowance would be made for what is clearly a pass-through event. ESC staff have suggested that in order to include an allowance for 5MS, there would need to be evidence presented to the ESC of the costs to implement for each retailer, and then a decision would be made as to what (if any) percentage of these costs might be considered efficient for the market as a whole.

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This is very concerning. While the approach taken in the Draft Decision might be appropriate for a monopoly business with a regulatory framework that includes 'overs and unders' type cost recovery, in a competitive retail market, where the price is based on the costs of an efficient retailer this has little relevance.

It appears based on the Draft Decision that the ESC would need to see significant costs incurred by all businesses before a pass-through event was considered. It appears that the fact that some businesses are expected to retire old systems and develop new ones to coincide with the implementation of 5MS might be considered pertinent in determining whether or not the costs of 5MS are efficient.

The AEC contends that regulatory change will always come with costs, and retailers should always be able to recover the efficient costs of implementation in the VDO. When assessing the relative benefits of the regulatory change, the ESC and other rule makers are required to undertake an assessment of the relative costs and benefits before determining the change is efficient. This assessment includes comparing the expected reduction in electricity prices to customers over time, with the implementation costs in the short term.

In the 5MS decision, the AEMC noted that the benefits to customers over time through reduced wholesale costs would be significant, and this offset the likely large one-off implementation costs expected to be incurred by some participants. While these benefits will be realised over time, the implementation costs will be incurred immediately.

The Draft Decision appears to disregard this fact, and in the absence of the AEMC publishing a formal cost benefit assessment renders it unable to make an accurate determination of the relevant costs to retailers. In its place, the ESC is asking retailers to provide their forecast actual costs (for a project that will not be implemented until October 2021), and the ESC will make a determination as to whether or not these costs validate the need for an allowance in the VDO. This approach means that for any regulatory reform, it will be incumbent on industry as a whole to prove that implementation costs are efficient. This approach does not allow any certainty to retailers that they will be able to recover their costs in the long term.

The AEC considers a preferable approach would be for the ESC to clearly define an approach to ensuring retailers are able to recover efficient CAPEX costs arising from regulatory reforms in a future year VDO calculation. In the absence of an ex post recovery mechanism, these decisions will need to be made on an ex ante basis, using predicted or modelled outcomes. Setting a clear approach such as this will then incentivise retailers to seek to optimise their own system developments to meet or beat these targets, enabling retailers confidence that they will be able to recover efficient costs and ensuring that the impacts of under-recovery do not unreasonably disadvantage engaged customers.

COVID pandemic costs

The Draft Decision suggests that insufficient evidence has been provided by retailers to suggest that a material increase in costs will arise from the COVID pandemic. It notes that while some retailers provided evidence of costs incurred in 2020, the majority of these costs will not continue into 2021.

Retailers have made public statements that they expect significant increases in bad debt and cash flow costs when macroeconomic Government stimulus ends at the end of 2021. The AEC notes the EY report[2] commissioned by the ESC as part of this draft decision reiterates this likely outcome.

What is challenging however, is the inability of any stakeholder, including the Government, to accurately predict the impacts of COVID-19 into 2020. In its budget recently released in early October, the

[2] Impact of COVID-19 on the efficient costs for retailers to supply electricity

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Commonwealth Government made assumptions that internal borders would be closed until the end of 2020, and international borders closed until late 2021. The assumptions included that a vaccine would not be available until late 2021.

These assumptions are worse than those considered by EY in its interim report.[3] Given this clear uncertainty, suggesting that retailers provide quantifiable evidence of the expected impact is implausible, and highlights the need for the ESC to consider an ongoing methodology for costs that are either unexpected, or unable to be quantified at the time of a VDO determination. As noted above, in the absence of an ex post mechanism to recover undervalued costs, the ESC must make predictions to provide retailers certainty.

The AEC encourages the ESC to continue to monitor the data provided by retailers voluntarily throughout the pandemic, in particular considering any impacts post the reduction in JobSeeker and JobKeeper payments in late September. Of particular early concern is the number of customers not actively paying, but not actively receiving support under the payment difficulty framework. These indicators will enable forward projections of the scope of retailer bad debt in the coming 12 months. Additionally, the ESC should consider the impact of retailers not disconnecting customers for a 6-12 month period. Whilst some of these customers would be receiving support under the PDF, the majority (currently less than 50% of customers are reconnected after a disconnection by the same retailer, indicating an unwillingness to pay[4]) are continuing to accumulate debts that will never be repaid, and ultimately written off by retailers. This number is material. In 2018/19 there were more than 36,000 disconnections, indicating more than 18,000 customers who would otherwise have been disconnected in 2020 are accumulating debts retailers are unable to mitigate. While the AEC is not suggesting these steps have not been warranted, expecting retailers to carry the whole burden of what is a public benefit response is unreasonable.

Evidence of cost reductions

While the Draft Decision states that retailers have failed to provide evidence that costs in certain categories will rise in 2021, it appears to accept assertions made by consumer advocates and others that benchmark costs should decline year on year so as to further reduce the VDO.

The AEC expects the ESC to treat cost reductions and increases equally, to ensure that the VDO meets its objective of providing a fair price for customers who do not wish to engage, but not to the detriment of engaged consumers. As noted above, the ESC appears to be relying upon principles common in monopoly price regulation, without genuine evidence as to why these concepts are directly applicable to ongoing price regulation in a competitive market. The VDO is unique in that the Victorian Government intends it to operate in conjunction with an effective competitive market in perpetuity, yet the ESC has not developed any mechanisms or methodologies that are responsive to the particular needs of the Victorian energy market. This is a shortcoming, and the AEC expects steps will continue to be taken by the ESC to allow the VDO to deliver upon its intended objectives, without continuing to disadvantage engaged energy consumers to the extent it has to date.[5]

The AEC strongly opposes arbitrary productivity factors, justification of cost reductions by identifying line items in the ASX reports of listed retailers, and inconsistent application of genuine costs. These approaches must be better considered in future years to ensure retailers remain confident to invest in the Victorian energy market, to the benefit of Victorian consumers.

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[3] Ibid
[4] Victorian Energy Market Report 2018-19 Appendix – Energy retail products and prices
[5] The impacts of price regulation on price dispersion in Australia's retail electricity markets, Ryan Esplin, Ben Davis, Alan Rai, Tim Nelson, Energy Policy.

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The AEC would welcome the opportunity to continue to work with the ESC in the leadup to the final decision to ensure that the 2021 VDO enables retailers to recover their efficient costs, particularly given the changing economic environment in Victoria. For any questions about our submission please contact me by email at ben.barnes@energycouncil.com.au or on (03) 9205 3115.

Yours sincerely,

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