

20 October 2020

Essential Services Commission  
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Melbourne Victoria 3000



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Dear Commissioners

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**Victorian Default Offer to apply from 1 January 2021 – Draft decision – September 2020**

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EnergyAustralia is one of Australia's largest energy companies with around 2.5 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 capacity.

We appreciate the opportunity to engage with the Commission in setting the Victorian Default Offer (VDO) for 2021. Our submission provides further detail to support the Commission's final decision with respect to:

- the Commission's conceptual approach and how this relates to efficient costs
- supplementary information that can improve its 'top down' assessment of the reasonableness of its VDO allowance
- our recommended approach to estimating costs of procuring certificates for complying with the large-scale renewable energy target (LRET), which produces a more accurate estimate of efficient costs and includes the use of 'observed' market prices for traded certificates
- timing issues in relation to network pricing approvals and the length of future VDO determinations
- retailer operating costs, including confidential data on COVID-19 impacts and five-minute settlement (5MS)
- data to inform the Commission's consideration of loss factors.

If you would like to discuss this submission, please contact me on 03 8628 1655 or [Lawrence.irlam@energyaustralia.com.au](mailto:Lawrence.irlam@energyaustralia.com.au).

Regards

**Lawrence Irlam**  
Regulatory Affairs Leader (acting)

## **The Commission's VDO approach should be internally consistent and demonstrably efficient**

The design of the VDO as set out in the Victorian Government's Order in Council, provides that it be set at efficient costs, and with a "modest" allowance for acquisition and retention costs. While these design elements are outside the Commission's control, we have some suggestions on how the Commission might determine these values in a way that reflects sound regulatory practice and ultimately satisfies the Commission's obligations in the Order in Council, the Essential Services Commission Act and the Electricity Industry Act.

The Commission should formulate a transparent and internally consistent approach to determining the VDO. Doing this would make it easier to demonstrate to all stakeholders that its allowance reflects efficient costs. Specifically, clause 12(3) of the Order in Council states that a VDO price determination "must be based on the efficient costs of the sale of electricity by a retailer". The Commission has not yet clearly defined this in practice. A simple analysis of efficiency, and one frequently used in price regulation of utilities, involves consideration of inputs, outputs and environmental factors that affect how a business incurs costs and delivers services to a relevant group of customers or market segment.

Applying such a fulsome framework would improve how the Commission combines a range of information sources to construct a set of prices or average bill amount. At present, the Commission uses forecast cost estimates derived from models or theoretically-based approaches (e.g. in the case of wholesale electricity costs and environmental costs), while for the cost to serve, acquisition and retention costs, and retailer margins, the Commission uses a range of information, including retailers' actual data, allowances from the decisions of other regulators, and ad hoc information from submissions. Only in the case of environmental costs and wholesale energy costs has the Commission recently noted the need to maintain consistency in its conceptual approach, yet it would appear that the Commission has not applied this logic to the entirety of the cost stack (see callout box below).

The Commission's draft decision identifies its considerations in satisfying legislative obligations as a separate appendix. We recommend the Commission better integrate these considerations into its final determination to substantiate the validity of each part of the VDO and to improve the transparency of the Commission's reasoning.

In exploring concepts of efficiency, competition and financial viability, we recommend the Commission genuinely engage with all retailers and conduct a forensic examination of the financial data it is now regularly collecting. It should also consider service delivery, including important concepts like brand recognition, as well as more direct measures of output. Contrasting to the DMO, the VDO requires properly determining 'efficient' prices and this cannot be done in a light-handed manner.

## Who is the notional efficient retailer?

The Commission must determine the VDO “based on the efficient costs of the sale of electricity by a retailer”. The Order in Council does not provide guidance what this means in practice, outside of listing various elements of the cost stack. Clause 12(8) states that the Commission is not required to determine tariffs based on the actual costs of a retailer. However actual costs incurred provide important information on what might be regarded as efficient, and the Commission has now requested actual costs for four financial years in two separate data requests.

The Commission’s approach to date reflects the amalgam of conflicting stakeholder views, consultant advice, public and confidential data. This has led to a patchwork of approaches to setting individual cost items in isolation, without clear regard to whether they align conceptually, or in reality:

- The Commission’s approach to wholesale energy costs likely reflects the practices and costs of larger retailers, rather than smaller retailers who may have higher shaping costs, lack of diversity in their customer base and different hedging practices. The Commission does not recognise energy purchases from long-term power purchase agreements (PPAs).
- For LRET liabilities, the Commission’s approach also ignores PPAs as the primary source of large-scale generation certificates (LGCs) for many retailers, and instead emulates small retailers or new entrants who instead procure LGCs from the market.
- For retailer cost to serve, published information suggests large divergences between large and small retailers, likely reflecting economies of scale, however the Commission has not explored how these and other operational factors are reflected in its allowances.
- The Order’s requirement for a “modest” allowance for customer acquisition and retention costs (CARC) reflects more established retailers rather than smaller retailers or new entrants that would likely incur higher acquisition costs to gain market share.

A deductive approach would be to, as other regulators have done, firstly define whether the retailer is, for example, vertically integrated or stand alone, provides gas (and potentially other services) as well as electricity, is largely based in Victoria, is government owned etc. These factors would then guide the assimilation of data from a range of sources for individual cost items, which the Commission does in the absence of a clear conceptual framework.

The “efficient costs of the sale of electricity” could also be construed with respect to the customer(s) being served under standing offer particular contracts. This might suggest exploring the efficient costs incurred by a larger, vertically integrated tier one retailer, as these retailers serve around 95 percent of all Victorian standing offer customers. (Source: ESC, VEMR 2018-19)

The Commission’s approach to loss factors and metering costs also imply ‘efficient costs’ reflect serving customers that reside in urban network areas and have basic meter types.

### Assessing efficiency is an empirical exercise and the Commission’s ‘top down’ checks using market offers is too simplistic

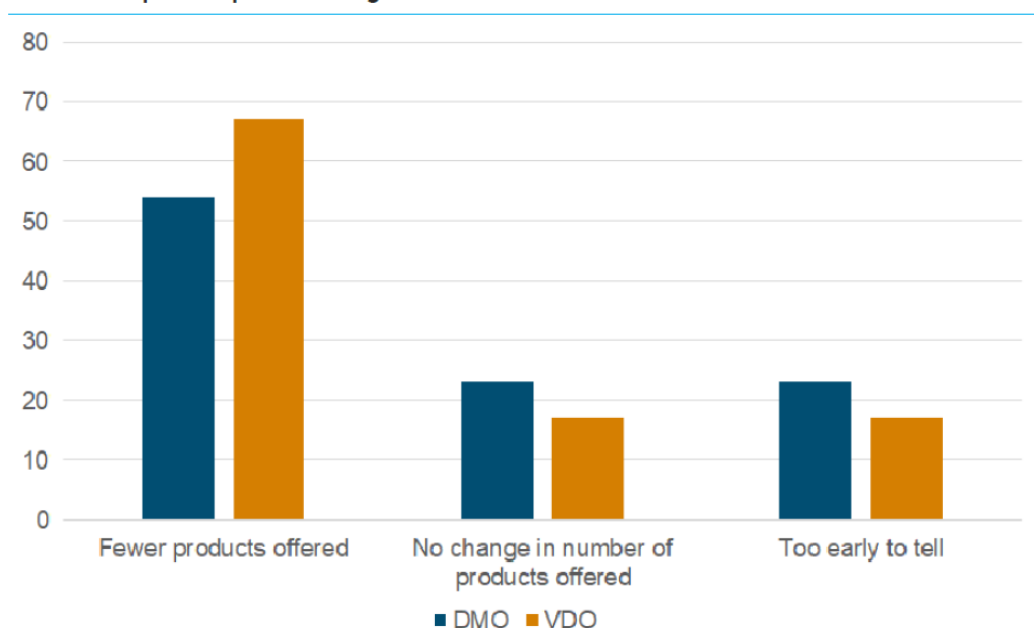
Even if the Commission were to use an internally coherent and complete approach to estimating efficient costs, we acknowledge the practical challenges in quantifying what is ‘efficient’ and so support the Commission using top-down checks of its overall VDO amounts. The Commission’s preferred approach appears to be to rely on recent market offers published on Vic Energy Compare.

Information presented in its draft decision, and at the Commission’s recent public forum, indicates that the VDO is below approximately half the average customer revenue derived from these offers. The Commission’s conclusion from this analysis is that its VDO is adequate in compensating retailers.

The Commission’s analysis would be improved with a closer examination of retailer costs, noting it now has at least two years of financial data from retailers. Use of cost and revenue data would be particularly useful now given concerns around uncertainties arising from COVID-19. For example, costs could be projected forward with sensitivities on key inputs e.g. bad debt allowances. The point of this exercise would be to see whether the Commission’s VDO allowances would result in retailers, on average, recovering the Commission’s benchmark EBITDA margin given their own likely costs. Such analysis would better substantiate any conclusions regarding financial viability or other the Commission’s legislative obligations.

The Commission should also deepen its understanding of how pricing activities have been impacted by price regulation and reference price requirements. This would include examining the withdrawal of offers and compression in the spread of offers that could skew any time series analysis using information drawn from Vic Energy Compare.

**Figure 3.6: Retailers indicate the impact on products and services of the re-introduction of a price-cap on standing offers**



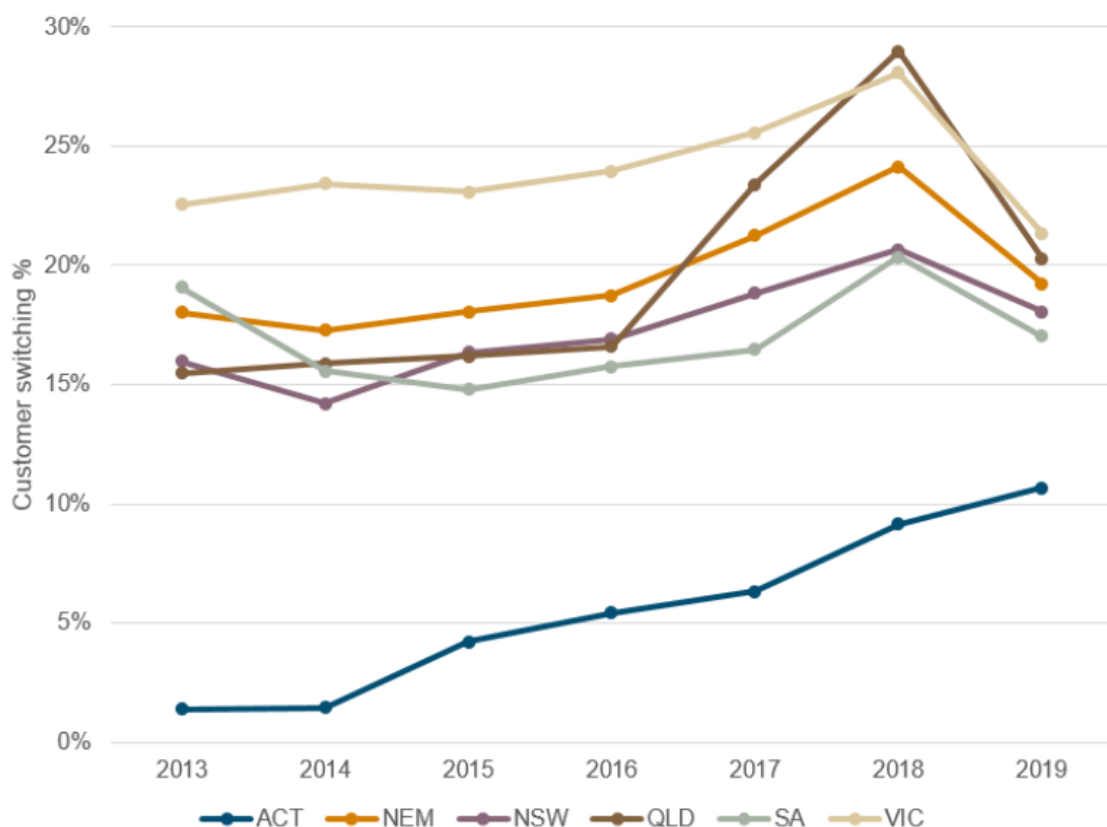
Source: AEMC<sup>1</sup>

<sup>1</sup> AEMC, 2020 Retail energy competition review, Final report, 30 June 2020, p. 34.

The Commission has stated that the VDO is consistent with the objective of developing retail competition because retailers are free to price above and below the VDO.<sup>2</sup> Comments by Commission staff at its recent public forum suggest that products priced above the VDO likely reflect additional value. We are interested in seeing more detailed analysis regarding the efficiency or otherwise reflected in market offer prices which would substantiate such a claim.

In terms of data suggesting the VDO is supportive of retailer viability and competition, the Commission has noted that four retailers have recently applied for licences in Victoria.<sup>3</sup> We suggest that market entry has likely been attractive for retailers with shorter-term hedging positions than existing retailers, and given recent falls in wholesale prices. The Commission has also suggested that reductions in switching rates in Victoria reflect “a downward trend in customer transfer volumes in Victoria for roughly 12 months before the first VDO price determination (mid-2018)”.<sup>4</sup> Data published by the AEMC appears to contradict this, showing a sharp reduction in switching in Victoria and indeed all states where retail price regulation was introduced in 2019.

**Figure 5.1: Overall consumer electricity switching**



Source: AEMC<sup>5</sup>

<sup>2</sup> Essential Services Commission, *Victorian Default Offer 2021: Draft Decision*, 15 September 2020, p. 65.

<sup>3</sup> *ibid.*, p. 33.

<sup>4</sup> Essential Services Commission, *Victorian Default Offer 2021: Consultation Paper*, 16 June 2020, p. 14.

<sup>5</sup> AEMC, *2020 Retail energy competition review, Final report*, 30 June 2020, p. 84.

## Further substantiation of our approach to accurately estimating LRET costs

The Commission noted its draft decision allowance for LRET costs was validated by comparing it to actual retailer costs. We understand that this validation involved the following:

- gathering retailer reported costs for 2017-18
- combining environmental and wholesale energy costs, recognising that PPAs involve the supply of both
- comparing this to its VDO allowance for January to June 2019.

This approach does not validate the accuracy of the Commission's allowances because:

- LGC prices reflected in first VDO were above \$60 per certificate, however the Commission is attempting to validate an approach that now compensates retailers for prices that are around half of this amount i.e. the market has changed significantly in the last year
- Prices for LGCs traded in the market around 2017-18 were likely reflective of long run PPA costs, hence this validation approach also confirms that a long run LGC price of \$60 per certificate appropriately compensates retailers
- The VDO's benchmark wholesale energy costs are around \$100 per MWh. Retailers' actual wholesale costs would easily vary by several dollars around this amount. When combined with environmental costs, this wholesale cost variance would more than offset the under-compensation arising from the Commission's LRET cost benchmark (i.e. around \$2 per MWh).<sup>6</sup>

We accept that conceptually it is correct to recognise the energy component arising out of PPAs as well as the green component. However, the value of energy derived from PPAs small relative to a retailer's hedge book, and the per MWh energy cost is also unlikely to materially diverge from broader hedging contracts.

Appendix A contains a calculation of weighted average LGC prices, using data provided by Green Energy Markets<sup>7</sup> (a reputable and independent market advisory service) on retailers' holdings of LGCs.

Long-term PPAs struck over the past decade are likely to reflect LGC prices of between \$40 to \$50 per certificate. The Commission now also has at least two data points in its own historic datasets collected from retailers. From this information it can "back out" LGC prices for each retailer.<sup>8</sup>

The PPA volumes and prices contained in our calculation can be validated by requests to the respective retailers with minimal effort. We have submitted such information on EnergyAustralia's agreements to the Commission separately.

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<sup>6</sup> The Commission's draft decision for 2021 estimates LRET costs of \$6.49 per MWh associated with LGC price of \$34.44. As outlined below, we consider the efficient LGC price to be around \$44, or 30 per cent higher.

<sup>7</sup> <http://greenmarkets.com.au/>

<sup>8</sup> Specifically, total energy sales multiplied by RRP provides the number of certificates surrendered. This can be combined with the total costs reported for LGC purchases to derive a per certificate price.

Our recommended LGC price, which we consider is transparently derived, based on independent data and, most importantly, reflective of efficient costs, is \$43.83 per certificate. This is the weighted average certificate price across the entire Victorian mass market. The full table reflecting this derivation and input data is at appendix A.

	<b>LGCs '000</b>	<b>Price \$/LGC</b>	<b>Comment/ source</b>
Vic Retailers' PPA LGC offtake	2,824	\$45.00	Long-term contracted volumes from Green Energy Markets, mid-point of prices from assumed range (\$40 to \$50 per certificate), and national LGC portfolio apportioned to Victoria
Vic Retailers' LGCs from OTC Market	351	\$34.44	LGC price using Commission draft determination and method
<b>Total liability for VDO applicable customers</b>	<b>3,174</b>	<b>\$43.83</b>	Volume weighted average price

### Timing issues relating to the next VDO determination

We support the Commission making a 7-month VDO determination from 1 January 2021, followed by an 11 month determination from 1 August 2021.

The Commission's draft decision to make a 12 month determination continues on the issue of misalignment between network costs and the VDO, and needs to be resolved eventually. Our preference is for the Commission to create this alignment sooner rather than delay this into 2022.

The Commission's draft decision of making of a 12 month determination, with a network cost pass through from July 2021, has the drawback of further price changes for customers without the benefit of aligning network prices and the VDO. Specifically, while the VDO would be changed from 1 July 2021 and accommodating network price changes, retailers would still face delays in receiving the Commission's new VDO and effecting price and marketing changes until after 1 July. The resulting misalignment of price changes for market offers and standing offers, and associated reference price comparisons, would create confusion for customers and additional workload for retailers. While the Commission notes that the VDO does not affect retailers' ability to change market offers when they need, price increases can only be applied at the time network prices change under its "fair contracts" decision.<sup>9</sup> We expect Victorian network prices to decrease in 2021, and increase thereafter. A 12 month VDO determination for 2021 therefore creates a potential issue in costs justifying an increase in market offers in line with a change in the VDO from 1 January 2022, given network prices will not change on this date.

A seven or eight month determination from 1 January 2021 also allows the Commission to revisit other elements of the cost stack, particularly retailer cost to serve, at a time where COVID-19 impacts will hopefully be easier to predict. Locking in retailers and customers for 12 months from January 2021 is not ideal in this regard. Government assistance is likely to change around or shortly after this time, placing strain on our

<sup>9</sup> Essential Services Commission, *Ensuring energy contracts are clear and fair: Final decision*, 28 February 2020.

customers, with impacts on retailer debt and in extreme cases, negative impacts on their financial viability.

Should the Commission proceed with a 12 month determination, with a provision for network price pass throughs from 1 July 2021, we strongly recommend that the full amount of network price change is reflected in any mid-year adjustment. That is, making any changes subject to a materiality threshold will result in a misalignment between VDO prices and efficient costs, which would be inconsistent with the requirements of the Order in Council.

We also note that from 1 July 2021 we expect changes in the definition of time of use periods, which will require the Commission to develop corresponding usage profiles. This will require some lead time, including likely consultation with retailers and network businesses to gather and process associated data. That is, it will not simply be a matter of altering the prices of tariffs underlying the VDO determination but altering the structure of tariffs and associated reference pricing requirements.

### **Bottom up estimation of retail operating costs is necessary**

Our prior submission recommended that the Commission make better use of retailers' actual data. The Commission's approach since the first VDO has been to place heavy weight on benchmarks estimated several years ago, with ongoing debates with retailers about ad hoc adjustments to this amount. This approach will never adequately resolve the ongoing issues raised by retailers regarding the higher cost of selling electricity in Victoria given additional regulatory requirements introduced by the Commission and the Victorian Government. The Commission has noted several times that retailer data on these jurisdictional-specific costs are not forthcoming. EnergyAustralia does not separately track the cost of all these interventions – they are embedded in various activities and many are now business as usual. If this is the case for other retailers, the Commission will need to accommodate these costs through trend or aggregate assessments rather than in isolation, noting the assessment of larger discrete changes like SMS and COVID-19 will be necessary at times.

In properly examining retailer costs we support the Commission exploring the presence of cost reductions and productivity gains. However, the reference to a "productivity factor" in the draft decision suggests the Commission intends to apply some sort of top down indexation approach. As discussed above, proper determination of efficient costs under the VDO requires bottom-up assessments. Properly constructed productivity measures also require considerable data on operational factors and service quality over time to establish robust trends. Our recommendation is that the Commission focus on establishing a robust benchmark in the first instance before considering methods to escalate this forward.

We understand the Commission's interest in cost reductions reflect the examination of information released to the ASX by Origin and AGL. As the Commission should be aware, the interpretation of reported data from retailers is subject to various pitfalls in terms of lack of comparability. Typically, operational cost savings are achieved through up-front investment in new systems. On this topic, we note the Commission's approach does not contain an explicit allowance for efficient capital costs, as amortisation is factored into the retailer (EBITDA) margin. The treatment of capitalised overheads is a further matter that the Commission is yet to mention in its VDO determinations. At present, the



Commission appears to assume that all corporate overheads are included in retail operating costs.<sup>10</sup>

As mentioned above we have various suggestions on how the Commission can improve its approaches to estimating efficient costs in general. As it relates to cost savings, we remain concerned that the Commission's current approach, without an internally consistent view of how a notional or actual retailer operates, would disallow a cost increase associated with implementing a program that resulted in subsequent cost reductions (as it would be above average retailer costs), but then would base future VDO allowances on the basis of the lower costs that result. This is essentially our concern with the Commission's approach to LRET costs, whereby large retailers made efficient investment decisions in the past to secure LGCs rather than pay penalties, but the Commission is now opting to rely on the cheaper prices of traded LGCs as the LRET has been satisfied.

### **COVID-19 and 5-minute settlement costs**

Our further substantiation of EnergyAustralia's costs for implementing SMS and dealing with COVID related costs is contained in confidential Appendix B of this submission. The Commission made the following comment regarding effect of the pandemic on retail operating costs:

We have not adjusted retail cost benchmarks to reflect the impacts of the pandemic, as we have insufficient information to justify any changes at this time. The cost estimates provided to us by retailers are based on assumptions about things such as future economic conditions and the extent of government stimulus.<sup>11</sup>

This is one of several reasons it cited for disallowing cost adjustments. However, we note that the entirety of the VDO determination is based on assumptions of what costs are likely to be incurred in the future.

On SMS costs, even if retailers were not forthcoming with data previously, we do not consider it a credible position for the Commission to assume retailers will incur zero costs as a result of this significant change in the market. We also note that there is published information suggesting the breakdown of industry-wide cost estimates. The following table was prepared by Russ Skelton and associates and presented at an AEMC public forum.<sup>12</sup> This suggests retailers would incur roughly half of the industry-wide costs of implementing SMS.

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<sup>10</sup> Essential Services Commission, *Victorian Default Offer 2021: Draft Decision*, 15 September 2020, p. 22.

<sup>11</sup> *ibid.*, p. 5.

<sup>12</sup> <https://www.aemc.gov.au/sites/default/files/content/52ce9f6e-8407-45e0-8fc8-34fec4ac8b29/12-Russ-Skelton-presentation-2.pdf>

## Costs of implementing 5 minute settlement

### Changes to business systems

- **Businesses will require major changes to:**
  - Wholesale market trading systems
  - Retail customer management systems
  - Risk management and reporting systems – often a complete re-write
- **Cost estimates based on input from a wide range of affected businesses**

System	Wholesale trading	Retail	Risk management
Range of cost estimates	From \$1M to \$15M	From \$0.5M to \$15M	From \$0.1M to \$5M
Total costs	\$54M	\$73M	\$23M

- **Total transition costs of approximately \$M 150**
- **Ongoing increased costs of approximately \$M 7 per annum**
- **Present value of costs over 15 years @ 5% discount rate – approximately \$M 200**

Source: Russ Skelton and Associates, 2017.

### Further information on loss factors

The Commission's draft decision notes its view that basing distribution loss factors on the short sub-transmission factor for each distribution zone as published by the AEMO is transparent and reflects losses for most VDO customers.<sup>13</sup> Our response to this view is:

- we have no issue with the Commission using AEMO's published loss factor data
- we dispute that, in the case of Powercor and AusNet's customers, the short sub-transmission factor is cost reflective, and the Commission appears to have formed its view in the absence of any evidence.

The interrogation of our own customer data for the two rural distribution zones suggests that using a short sub-transmission factor materially undercompensates retailers for the efficient cost of supplying customers in these zones. In the AusNet zone, 67 per cent of our customer usage in this zone is attributed to the long transmission distribution loss factor. Notably, as the ex-incumbent retailer in the AusNet zone, we service a large and representative number of customers. For Powercor this value is only 33 per cent, and note that our usage data could be less representative of the total as we service around 14 per cent of customers in this zone. Regarding marginal loss factors, around 75 per cent of our usage in the Powercor zone is greater than the parameter chosen by the Commission. We would be pleased to provide the Commission further data and request the Commission provide its own evidence to substantiate its view on appropriate distribution and marginal loss factors.

<sup>13</sup> Essential Services Commission, *Victorian Default Offer 2021: Draft Decision*, 15 September 2020, p. 14.

## Appendix A – derivation of weighted average LGC price for Victorian mass market customers

	DEMAND								SUPPLY		
	Vic Residential Customers <b>2018-19</b>	Vic SME Customers <b>2018-19</b>	Vic RESI energy MWh	Vic SME energy MWh	Vic Mass market energy MWh	Vic MM LGC Obligation (2021 <b>20%</b> )	MM LGC Demand National	Vic MM as a proportion of LGC portfolio	Retailers' National LGC PPA Offtake	Retailers' LGC Offtake Applied to Vic	LGC Offtake VWP
Source/Formula	A	B	C	D	E	F	G	H	I		
	VEMR Table 1.4	VEMR Table 1.5	= A * <b>4MWh</b>	= B * <b>20MWh</b>	= C + D	= E * <b>20%</b>		= F/G	GEM estimates	=MIN(H * I, F)	Estimate
								%	LGC	LGC	\$/LGC
AGL	557,035	51,481	2,228,138	1,029,615	3,257,753	651,551	2,279,459	29%	5,008	1,431	\$45.00
Alinta	151,215	7,818	604,860	156,353	761,213	152,243	548,803	28%	2,549	707	\$45.00
EnergyAustralia	425,406	38,191	1,701,623	763,817	2,465,440	493,088	1,692,718	29%	2,455	715	\$45.00
Lumo (SNOWY)	146,120	12,535	584,479	250,695	835,174	167,035	210,702	79%	2,756	2,185	\$45.00
Momentum (HYDRO TAS)	88,111	27,355	352,445	547,097	899,542	179,908	236,820	76%	1,984	1,507	\$45.00
Origin Energy	437,638	71,895	1,750,553	1,437,892	3,188,445	637,689	2,860,441	22%	2,400	535	\$45.00
Red (SNOWY)	232,135	8,610	928,541	172,205	1,100,746	220,149	505,349	44%		0	
Simply (ENGIE)	245,725	16,575	982,901	331,507	1,314,408	262,882	396,762	66%	734	486	\$45.00
Tango (PACIFIC HYDRO)	37,934	7,175	151,737	143,508	295,246	59,049	59,134	99.9%		0	
Other retailers	261,867	35,320	1,047,468	706,390	1,753,858	350,772	2,263,793	15%	0	0	\$0.00
total					15,871,824	3,174,365			17,886	7,567	\$45.00