AGL Energy Limited
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
t: 02 9921 2999
f: 02 9921 2552
agl.com.au

Victorian Default Offer 2022-23
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, Victoria 3000

Via email VDO@esc.vic.gov.au

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Victorian Default Offer 2022-23

On the 25 November 2021, the Essential Service Commission (ESC) released its *1 January 2022 Victorian Default Offer – Final decision* (Final Decision) for the Victorian Default Offer (VDO) prices that will apply until 30 June 2022. This Final Decision also requested stakeholder submissions on any matters the ESC may need to consider in its 2022-23 Victorian Default Offer.

AGL would like to take this opportunity to respond to the Final decision and highlight several issues that are relevant to the determination of the VDO prices for the 2022-23 financial year. The key areas which we have concerns with are:

- treatment of wholesale electricity costs due to the transition from a calendar year to a financial year, and
- compression of retail costs and margin.

Wholesale electricity costs

The current VDO prices reflect the estimated total costs for a retailer averaged over the 2021 calendar year.

The regulatory transition from a calendar year determination period to a financial year period creates several difficulties as VDO prices are required to change again on 1 July 2022. AGL supports the ESC's decision to, where possible, continue to use the same methodology as in previous determinations for consistency and transparency. This methodology will generally accommodate the period change as the annual estimates for the financial year will be reflected in the VDO prices and aligned with the time retailers incur these costs.

However, the current methodology will not adequately reflect the wholesale energy cost for an efficient retailer over these combined periods. AGL believes the ESC should make the necessary adjustment to its estimate for wholesale energy cost if it is to meet its legislative objectives.

AGL continues to generally support the market approach used by Frontier to estimate wholesale electricity costs and believes this is the appropriate methodology to estimate the underlying wholesale energy cost for 2022-23.

However, ASX Energy financial products are quarterly products, and the actual cost of hedging varies considerably on a quarterly basis. This is regardless of retailers' different hedging strategies and stated preference to set retail prices only once a year. The cost of hedging in the first half of a calendar year (specifically the Jan-Mar quarter or Q1) are significantly higher that the remaining quarters. The ESC acknowledged this in its Final decision:

> *"We accept that wholesale costs are likely to be higher in the first half of the calendar year than the annual average."*[1]

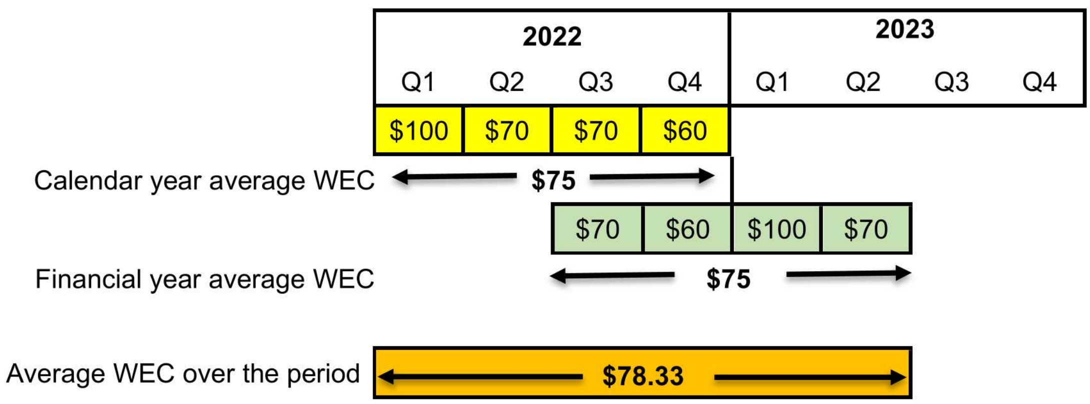
Consequently, if the ESC was to only update its wholesale energy cost for the 2022-23 VDO determination then this will result in any efficient retailer under-recovering its actual wholesale energy cost over the 18-month period because of the period transition.

Figure 1 highlights how this under-recovery occurs using a simplistic example. Its shows the indicative spread of quarterly wholesale electricity costs over the 2022 calendar year (Q1-Q4) and a resultant annual average wholesale cost of $75/MWh. This aligns with the ESC's current methodology.

Assuming the quarterly wholesale energy costs for 2022-23 are unchanged then the ESC's underlying methodology for estimating the wholesale energy cost will result in an annual average wholesale energy cost of $75/MWh for the 2022-23 financial year. This suggests no change in cost.

However, in this example, an efficient retailer's actual cost over the entire 18-month period is not $75/MWh but over $78/MWh as the retailer has had to spread the higher wholesale cost of the two Q1s over 18 months, not the 2 years or 24 months assumed in the ESC's methodology.

Figure 1: Average quarterly and annual WEC ($/MWh)



[1] *1 January 2022 Victorian Default Offer – Final decision*, page13

AGL believe that if the ESC uses its current methodology to calculate the underlying wholesale energy cost for 2022-23, a one-off adjustment would be required to account for the impact of the transition for the reason shown above.

The absence of such an adjustment would result in an efficient retailer not recovering its reasonable wholesale energy costs over the 18-month period.

This would appear to conflict with the pricing order and the ESC Act[2], which requires the ESC to consider factors including efficiency in the industry and incentives for long term investment, the costs of regulation for regulated entities and the financial viability of the industry.

Retail Costs

The basis of the retail operating cost benchmarks used for the current VDO has been attributed to the 2017 ICRC decision on ACT retail electricity prices. This benchmark can be traced further back to the IPART review of NSW retail electricity prices in 2013.

In addition to allowing for inflation, the retail operating cost benchmark for the VDO has been adjusted for the incremental cost of the payment difficulty framework in Victoria and the temporary incremental bad debt costs due to the pandemic.1

AGL has provided data to the ESC on its retail business, consistent with the data provided to the ACCC's Electricity Monitoring 2018-25. The cost data includes allocated corporate costs, and depreciation and amortisation expense. We understand that this data, as well as data from other retailers, are used to cross check the benchmark with the ESC's Final decision indicating its allowance is just below the customer weighted average of the range of actual retail costs provided by retailers.

In recent years, retailers including AGL have invested significantly in billing systems and programs to digitalise and transform customer experience and business operations, and to comply with industry and regulatory requirements. The costs of these technology would not have been considered when the IPART benchmark was established in 2013. While some costs will be displaced, expenditure on technology has increased significantly over time. According to accounting standards, these IT costs are amortised over a number of years. However, the retail operating cost benchmarks established by regulators have generally excluded depreciation and amortisation costs.

Therefore, in AGL's view, the underlying retail operating cost benchmark is out of date and does not include all the costs of operating a retail business.

Customer acquisition and retention costs

The ESC has acknowledged that data provided by retailers showed that acquisition costs have continued to grow and that the benchmark set for customer acquisition and retention costs (CARC) is below retailers' actual costs. Accordingly, the ESC should consider whether the benchmark for CARC needs to be increased whilst maintaining a modest allowance in accord with its Pricing Order.

[2] Section 8A(1)(b) of the ESC Act.

Retail operating margin

The retail margin benchmark of 5.7 per cent was based on previous regulatory decisions which can also be traced back to the 2013 IPART review. Since 2013, there have been significant industry and regulatory changes in the wholesale and retail energy markets. These changes create financial, operating and compliance risks which in AGL's view, support a higher allowance for retail operating margin, especially when considering that the effective average retail margin is lower than 5.7 per cent because of:

- understated components of the cost stack such as operating cost, VEU costs or CARC; and
- the lack of any competitive allowance results in market offers providing lower retail margins.

If you have any questions in relation to this submission, please contact Patrick Whish-Wilson on pwhish-wilson@agl.com.au or Meng Goh on mgoh@agl.com.au.

Yours sincerely

Elizabeth Molyneux
GM of Policy and Market Regulation