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Dear Chairperson and Commissioners,

Draft decision – VDO from 1 January 2022 – PUBLIC VERSION

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise 4,500MW of generation capacity.

We welcome the opportunity to provide this submission on the ESC's Draft Decision for the VDO commencing 1 January 2022 (Draft VDO).

1. 12-month average wholesale electricity cost approach for a six-month VDO

As per our previous submissions, our key concern relates to calculating wholesale electricity costs for a six-month VDO and the need to ensure the appropriate recovery of the higher Q1 2022 wholesale electricity costs.

This issue arises because the current VDO methodology effectively averages the wholesale electricity costs over the four quarters of a year. These costs are different across the quarters due to seasonality, with Q1 costs being significantly higher. Adopting a 12-month wholesale electricity cost average for a VDO that only covers six months (H1 2022) (and the six months with the higher Q1 costs) would result in an under-recovery of those higher Q1 costs. This issue is not resolved in the subsequent regulatory period for financial year 2022-2023 as that forms part of a separate 12-month period.

We remain concerned that for the 2022 period, **there would be an under-estimate of wholesale electricity costs which would fail to ensure that the VDO is based on the efficient costs of the sale of electricity by a Retailer, as required under the relevant Order in Council**.[1] We

[1] Clause 12(3), Victorian Government Gazette, No. S 208 Thursday 30 May 2019

refer to our previous supplementary submission to the Consultation Paper for our main reasons for this view.[2]

In this submission, we address what has changed since H2 2019 (which set a six-month VDO that used a 12-month wholesale electricity cost average); and address the ESC's other considerations around this issue.

1.1 What has changed since H2 2019?

The ESC seems to acknowledge that there will be an under-recovery in 2022 of wholesale electricity costs, but has pointed to its H2 2019 decision which adopted a 12 month average wholesale electricity cost for a six month VDO – basically suggesting that H2 2019 allowed for an over-recovery which would balance out the under-recovery of wholesale electricity costs in H1 2022.

The ESC has asked what has changed since H2 2019 when Retailers advocated for a 12-month weighted average wholesale price. **Since H2 2019, section 46AA of the *Energy Retail Code* has been introduced which is a key change.** This section prevents Retailers from raising Market Offer prices more than once a year (except for limited exceptions). This would likely constrain Retailers in adopting Retail prices that are shorter than a year. **This means even if Retailers wished to set a six month retail price (which according to the ESC's reasoning might warrant the ESC reconsidering the 12 month average approach, discussed more below), they are highly unlikely to.**

1.2 ESC's other considerations - Retail pricing and hedging approaches

In the draft decision, the ESC proposes to use a 12-month weighted average wholesale price for the six-month VDO. The ESC explains:

> "Our view is that it is appropriate to calculate the level of future prices based on forecast wholesale prices for a whole year. This is consistent with our understanding that Retailers would generally set prices expecting to serve customers for more than six months."

We understand the ESC's logic when considering how to set the VDO generally for a typical 12-month VDO. However, this particular under-recovery issue only arises due to the special circumstance of setting a VDO that has a 6-month regulatory period. i.e. The issue would not arise if the VDO was set for a 12 month period. In our view, what Retailers do generally in setting their retail prices is not relevant given these special circumstances that arise in setting the regulated price for a shorter period than Retailers would normally set prices for.

To illustrate the point: common Retailer practice is to set Retail electricity prices for 12 months. Accordingly setting a VDO regulatory period for 12 months (based on a 12 month average wholesale price) makes sense as it reflects market practice. However, this particular issue arises because the VDO regulatory period has departed from common market practice and has been set at six months.

We understand the ESC is also interested in understanding if hedging approaches have changed since H2 2019. We do not see hedging approaches as relevant to this issue. The ESC may be using the term 'hedging' in a different context.

[Confidential:

] This issue regarding the 12-month weighted average wholesale price is separate to hedging approaches. It concerns whether the VDO will allow the recovery of efficient wholesale electricity costs and the amount of wholesale electricity costs allowed to be recovered (which Frontier's

[2] Located on this webpage, Victorian Default Offer price review 2022 | Essential Services Commission

methodology calculates to be mostly hedged but with some unhedged costs (a small amount of pool exposure)).[3]

We also consider that the period in advance that a Retailer chooses to hedge its wholesale price risk, is also not relevant to this issue. This relates to the period in advance that a Retailer is seeking to manage the risk of prices it will be exposed to in the future. i.e. a Retailer may enter into hedging contracts for the electricity it forecasts that it will need to purchase in two years. It has therefore "hedged" two years in advance. This is a timing issue which does not relate to the amount of wholesale electricity costs allowed to be recovered under the VDO which is changing due to the regulatory period being changed from 12 months to six months.

In the Draft Decision, the ESC also appears to suggest that if there was an under-recovery it would not affect Retailers' financial viability because most Retailer's customers and revenues come from Market Offers and not Standing Offers. It states:

> "In addition to the fact that we consider our approach allows Retailers to recover efficient costs we also note that Standing Offers cover a very small share of total customers for most Retailers. Most Retailers' customers and revenues come from Market Offers."

[**Confidential:**

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We consider the financial viability issue should be considered in relative terms. That is, a material under-recovery in the VDO price should still be considered material even though it is only a price cap for Standing Offers. The impact should not be minimised by reason of Standing Offers only making up a very small share of total customers. To take this view would result in minimising the effect of the financial viability matter when seeking to achieve the objective under the *Essential Services Commission Act 2001* (which the ESC must have regard to when considering the VDO pricing methodology).

2. AEMO charges – some costs appear to not be accounted for in the VDO

The ESC's outline of Australian Energy Market Operator (AEMO) costs at page 65 of the Draft decision (extracted below) does not appear to account for AEMO's costs of five minute and global settlement reforms and the Distributed Energy Resources (DER) Integration Program. These new cost components were introduced in AEMO's 2021-2022 budget[4], and would total around $0.15/MWh. The current five minute settlement allowance in the VDO ($0.84) reflects Retail operating cost only which is different to AEMO costs. We submit that the VDO should be increased to reflect these additional AEMO costs.

[3] https://www.esc.vic.gov.au/sites/default/files/documents/21-08-30%20Frontier%20-%20wholesale%20electricity%20costs%20-%20draft%20report%20-%20STC.pdf , p 32

[4] https://aemo.com.au/-/media/files/about_aemo/energy_market_budget_and_fees/2021/aemo-2021-22-budget-and-fees.pdf?la=en

Charge	Rate
National Electricity Market fees	$0.40/MWh
Full retail contestability	$1.35/customer
National Transmission Planner	$0.00/MWh
Energy Consumers Australia	$0.62/customer
Ancillary services	$0.30/MWh
Reliability and Emergency Reserve Trader	$0.00/customer

3. Significant increases to Victorian Energy Upgrades costs

Given the changes in the Victorian Energy Upgrades (VEU) scheme, the ESC is open to considering other ways to forecast prices.

As the ESC is aware, VEU certificate prices have increased significantly in the last six months. This is due to:

- The Victoria Government reducing the emissions factor (number of certificates created per MWh of electricity offset) due to the expected decline in emissions intensity in Victoria following the closure of Hazelwood. This means each certificate is worth less, leading to the need to buy more certificates.
- Phasing out established activities like lighting (which constitute up to about 80% of the scheme). New activities like demand response are still being established and are not widely available. This creates tightness in supply.
- COVID-19 restrictions further exacerbating the supply side issues.

This points to broader issues with the VEU scheme and Victorian Government decisions which will persist for some time. These issues would only be resolved by a reduction in VEU targets for 2022.

Insofar as the VDO is concerned, we seek an increase in VEU costs in the 2022 VDO to reflect the higher market costs. The ESC's Draft VDO allows for $49 per certificate in VEU cost, but the market certificate price is around $79. The ESC could bring forward an advance increase to VEU costs in the VDO to reflect the materially higher VEU costs for 2021 resulting from changes by the Victorian Government.

This upwards adjustment would retain the ESC's weighted average price for certificates over the last 12 months but multiply it by a percentage adjustment to reflect the higher costs. The amount could then be "trued up" later. As this "true up" would operate both ways, to adjust for any under or over-estimate by the adjustment, it would not appear to shift price risk on to consumers (as mentioned in the ESC's draft decision). It would also not be departing from the ESC's weighted average approach in any substantive way as the same amount would be recovered by Retailers over multiple VDO periods. The only change would be to the timing of that recovery. This appears to be the simplest way to provide some relief on the issue, without fundamental changes to the ESC's pricing methodology.

Across the VDO determinations, it would work as follows:

a) VEU costs for H1 2021 period will be based on weighted average prices for certificates over last 12 months (25 October 2020 - 25 October 2021), multiplied by an upwards adjustment of 35%, or another reasonable proxy.

b) In the next VDO (FY 2022-23), the ESC would calculate VEU costs for the FY 2022-23 (based on 1 June 2021 – 1 June 2022 historic costs, different dates to reflect financial year). The ESC would either add or subtract any under or over recovery for the H1 2022 period calculated as the gap between (a) and the amount for H1 2022 based on actual historic costs (ordinarily October 2021- October 2022, but applied to the relevant VDO period).

c) In the VDO (FY 2023-24), assuming VEU costs have stabilised, the ESC would resume its usual approach to VEU costs based on actual historical costs (1 June 2022 – 1 June 2023), with no adjustment.

4. Distribution loss factors

The ESC intends to use the simple average of the short and long sub-transmission distribution factors, instead of using a weighted average approach to calculating distribution loss factors for both AusNet and Powercor regions. Having calculated a weighted average, the ESC has determined that there is less than half a per cent difference in customers' annual bills. We appreciate that the ESC has performed the calculations based on a weighted average approach, and ask that the ESC take a step further and use these calculations in the VDO determination to provide more accurate and efficient pricing outcomes.

The ESC's reasons to continue the simple average approach are around providing better transparency and ease of replication. The ESC also appears to imply that less than half a per cent difference is immaterial. **[Confidential**:

] The ESC's approach to recognise cost differences relating to bad debt and five minute settlement, but not the cost differences resulting from different loss factor calculations is inconsistent. These are further reasons for the ESC to adopt a weighted average approach.

5. Marginal loss factors

The ESC has retained their simple average approach to calculating marginal loss factors for transmission node identifiers (TNIs).

Our analysis shows that the ESC may have included TNIs which do not supply residential and small business customers (mass market customers).

[**Confidential:**

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Based on our calculations, excluding these TNIs would result in a marginal loss factor which is 0.4% higher than the ESC's calculation for the AusNet zone. Assuming $100/MWh in electricity cost (including green costs) this would be $1.60 per customer per annum.

At a minimum, the ESC should exclude these TNIs that do not supply mass market customers. Our preferred approach however is for the ESC to move to a weighted average approach for marginal loss factors. The current simple average approach is not an appropriate method to accurately reflect the loss factor as it is highly susceptible to outlier TNIs with substantially different values. This is not a material issue now based on the current TNIs because marginal loss factor values are favourable (and have changed to minimise the effect), but it has been worse in the past and could again be an issue in the future if the values change.
The current simple average approach for both distribution and marginal loss factors does not accurately reflect loss factors, with flow on effects to the recovery of efficient costs for multiple cost

components in the VDO. This is an issue that applies to every VDO determination, with cumulative impacts over the long term. We acknowledge that a weighted average approach for loss factors is more complex, but encourage the ESC to engage with AEMO and the networks to move towards it in the future.

6. Bad debt allowance

Several other Retailers have raised issue with the COVID-19 bad debt allowance being removed or substantially reduced under the next VDO. The COVID-19 situation is still highly uncertain and while restrictions are expected to lift shortly under the Victorian Government's Roadmap and businesses to re-open, it is unclear whether new measures will be introduced if the health system becomes over-burdened. The effects of the removal of government support later this year on customer ability to pay and bad debt levels is also difficult to forecast. If the ESC were to remove the bad debt allowance from the VDO, we strongly urge the ESC to remain open to providing a backward looking allowance should there be a significant change to the Victorian Government's roadmap implementation.

7. Section 46AA of the *Energy Retail Code*

We seek to clarify the ESC's summary of EnergyAustralia's submission on section 46AA of the Energy Retail Code.

We previously stated that allowing Retailers to link Market Offer prices to changes in the VDO supports the effectiveness of the VDO as a benchmark price against which all Market Offers are compared.

The ESC stated "It is not clear to us why Retailers would need to change their Market Offer prices in response to changes in VDO prices. Retailers might change their Market Offer prices based on changes in their underlying costs. Changes in VDO prices do not change Retailers' underlying costs."

Our point aligns with the ESC's statement. Our view is that Retailers might wish to align changes to underlying costs for Market Offer prices with changes to underlying costs of the VDO. E.g. change Market Offer prices for reductions in network tariffs, when the VDO changes for reductions in network tariffs. This helps to ensure that Market Offer comparisons against the VDO reference price are like for like.

If you have any questions in relation to this submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761)

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