12 August 2019

Essential Services Commission
Level 37
2 Lonsdale St
Melbourne Victoria 3000

EnergyAustralia Pty Ltd
ABN 99 086 014 968

Level 33
385 Bourke Street
Melbourne Victoria 3000

Phone +61 3 8628 1000
Facsimile +61 3 8628 1050

enq@energyaustralia.com.au
energyaustralia.com.au

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

Dear Commissioners

Victorian Default Offer to apply from 1 January 2020 – Issues paper – July 2019

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 capacity.

We appreciate the opportunity to provide feedback into the Commission's consideration of the Victorian Default Offer (VDO) from 1 January 2020. At present, the key issues we have with the Commission's methods relate to using a market approach to estimating costs associated with the Large-scale Renewable Energy Target (LRET) and in undertaking a robust assessment of retailer operating costs, including acquisition and retention costs.

As noted earlier this year, our expectation is that many retailers do not manage their LRET liability by purchasing certificates from the market but rather from contracts with renewable generation projects. We hope to work further with the Commission to demonstrate this is a prudent and efficient approach, and that the costs associated with this can also be transparently and robustly estimated. We also appreciate the opportunity to work with the Commission in examining retailer cost information that should similarly assist in estimating efficient operating and other costs.

We consider the Commission should base its maximum annual VDO bill on prices it determines for individual tariff components for non-flat tariffs. Approaches that allow retailers to set their own prices under a maximum bill constraint are likely to detract from the simplicity and transparency of the VDO, which ultimately benefits consumers.

Our response to the Commission's staff paper is attached. If you would like to discuss this submission, please contact Lawrence Irlam on [redacted] or [redacted]

Regards

Carmel Forbes
Industry Regulation Lead

LRET costs need to reflect off-market contracting

The Commission's final advice noted stakeholder concerns around using market-based approaches for estimating environmental costs, and stated that alternatives appeared to be retailer-specific and not representative of efficient costs.[1] It noted our concerns in using such an approach for specifically estimating LRET costs alongside concerns raised by AGL, who also suggested that power purchasing agreements (PPAs) were the main source of procuring large-scale generation certificates (LGCs). Aside from this, the Commission did not discuss efficient or prudent retailer practices. We reiterate our position that relying on the market price of LGCs will not produce an estimate of environmental costs that reflects the efficient cost of sale of electricity.

A retailer would be prudently incurring costs on the basis of market prices if it were a new or recent market entrant. The Commission was asked directly in earlier consultation whether it was basing its cost estimates on those of a new entrant retailer however provided no response.[2] Its earlier staff paper raised the prospect of defining the notional efficient retailer[3] but this has not been pursued by the Commission. There is nothing we can identify within the Order that guides the definition of 'efficient' in clause 12(3), nor is there anything that might guide consideration of 'prudence', which is the natural counterpart to 'efficiency' in economic regulation and is central to our concerns here. The Commission has defined prudent retailer practices in several elements of the cost stack, for example in taking a 12-month contracting approach for wholesale costs, and should be transparent in its approach to other retailer activities.

As the VDO has replaced standing offers, this suggests that costs reflect those of a retailer with a substantial number of standing offer customers. In the context of customer acquisition and retention costs (CARC), the Commission noted that the VDO was initially intended for customers who gained no benefit from marketing or retention spending, hence why CARC was to be excluded under the Thwaites recommendations.[4] However the subsequent inclusion of a modest CARC allowance in the Order suggests that an 'efficient' retailer may be one that supplies both standing offer and market offer customers.

We are unable to determine how the Commission concluded that procuring LGCs from PPAs was retailer-specific and unrepresentative of efficient costs. Absent any clear definition of the benchmark efficient retailer, we would be concerned if the Commission were determining efficient costs or practices on the basis of market prices being lower than contracted prices. Noting that the Commission has adopted a principle of representativeness[5], we also do not consider that retailer-specific practices would necessarily be inefficient under the Order. We acknowledge, however, that the Commission may have preferred to rely on market data as this is more transparent. Retailers may have not been forthcoming with contract data, and it may be difficult to validate such data or to synthesize them into a robust benchmark cost. However any such challenges are subsidiary to the Order's requirement that the VDO be based on efficient costs.

[1] Essential Services Commission, *Victorian Default Offer to apply from 1 January 2020 - Issues paper*, July 2019, p. 43.
[2] ibid, p. 56.
[3] Essential Services Commission, *Victorian Default Offer for domestic and small business electricity customers - Staff working paper*, December 2018, p. 6.
[4] Essential Services Commission, July 2019, p. 73.
[5] ibid, p. 18.

We recommend that the Commission seek data from retailers to examine the diversity of practices and the reasons for such diversity. Our expectation is that larger retailers, particularly incumbent retailers supplying a significant number of standing offer customers, have material contracted positions. Under a market approach, retailers who prudently contracted for LGCs will be unfairly penalised for underwriting large scale renewable generation as per the policy intent of the LRET. It may have been the case that the Commission's estimate of 2019 LGC prices (noting many stakeholders advocated for a 12 month average of 2019 prices) may have not been materially different to historically contracted LGC prices. However the market price of LGCs for calendar year 2020 is currently around $25, less than half of what the Commission estimated for the current VDO. Notwithstanding any unforeseen increases in renewable energy targets (unlikely in the current policy environment), this price will continue to fall for later years.

Scrutinising actual retailer costs is necessary but will take time and effort

We support the Commission issuing formal data requests to better understand retailer's actual costs, particularly operational costs and CARC, and exploring how these relate to other elements of the cost stack.

While clauses 12(8) and (9) of the Order expressly allow the Commission to set the VDO on the basis of benchmark costs, examining the actual costs of retailers will provide strong guidance on what is likely to be efficient. Noting concerns around the prudence of CARC expenditures, the efficiency of spending on CARC and all other activities will reflect the extent of competition in the market, which we consider is robust. The Commission's task of setting the VDO annually should also avoid the need to rely too heavily on forecasts or departures from historical trends. Controllable costs for retailers are also largely recurrent, notwithstanding new costs associated with major policy interventions or other changes in the market, which retailers should be well placed to estimate. The cost of complying with interventions such as the Payment Difficulties Framework will be distinct, while others, such as the introduction of the VDO, will have ongoing effects on items such as CARC or take several years to show in reported data.

To assist the Commission in developing templates and interpreting retailer data, our high level observations are:

- existing reporting templates developed by the ACCC are likely to be sufficiently detailed to examine and standardise major retailer cost categories. We would also support using these templates to minimise reporting burden (and costs) on retailers

- like the ACCC, the Commission will need to carefully examine how shared costs are reported, particularly for vertically integrated entities and those also involved in the supply of gas and other services

- different approaches to capitalisation are likely to materially affect reported costs and also need to be accounted for, particularly in ensuring that EBITDA margins adequately cover depreciation/ amortisation

- the data should give the Commission some information to validate claims that larger retailers have a cost advantage due to scale or incumbency, as well as

counter-claims that being the designated/ incumbent retailer results in higher or specific costs such as ROLR or bad debts

- the Commission may wish to separately identify the cost of retailer compliance with policy or regulatory interventions such as PDF or implementation of the VDO, at least to the extent these are not uniform across retailers or not captured as 'business as usual' costs in the data it collects

- while obviously focussed on costs, the Commission should also develop a robust measure of revenue. This is important in understanding the impact of items such as bad debts and unknown customers (i.e. revenue inefficiencies), which are material in determining measures of profitability.

Understanding the entirety of retailer costs and developing a 'standard' cost stack is a significant challenge which we expect the Commission will not be able to meaningfully resolve in time for the next VDO. The proposed timelines in the Commission's issues paper are already short. It does not have enough time to issue information requests and for retailers to respond before its draft determination. The Commission has roughly eight weeks between its draft and final determinations which we consider, based on our experience with ACCC information notices and the number of parties providing information, will only be enough time to identify areas where clarification and standardisation is required.

Further analysis would be necessary where the Commission intends to use this information to inform a view of efficient expenditures or the lesser task of simply combining retailer data into a representative set of costs to 'sense check' its benchmarks. This would require supporting data such as measures of marketing activity, customer load data, PPAs and the hedging policies of different retailers. In this context, the Commission should anticipate building on data templates over time and take a cautious approach, particularly if the data it initially receives indicates a wide range of costs or significant departures from benchmarks on which it has already relied.

The Commission should determine prices for non-flat VDO tariffs

Clause 10(2)(a) of the Order requires the Commission to determine the maximum annual bill amount in relation to the VDO applying to non-flat tariffs. The Order also defines the VDO as "simple" and "trusted" pricing option. We consider that price constraints applied in the form of bill amounts would lack transparency and be difficult to explain to customers. This would reduce their effectiveness in being a known, trusted price for standing offers. Prices for non-flat tariff components could be prescribed under the Order's requirements alongside maximum bill amounts.

The options identified by the Commission in setting maximum bills would allow retailers the flexibility to set compliant prices for a range of possible tariff structures. While this flexibility has advantages, the likely divergence in pricing practices across retailers will attract scrutiny and likely further allegations of "banditry" and greed[6], even if we act in good faith and comply with price determinations.

[6] Rolfe, J., Power bill banditry, *Courier Mail*, 5 August 2019, p. 21.

The Commission's preferred approach would not promote transparency

The Commission's preferred option to specify a maximum bill calculation would minimise significant price and bill variances depending on consumption values. It also appears to be explicitly designed to provide customers some certainty on how the VDO will apply to them in their specific circumstances. We disagree with the Commission's position, however, that this approach would promote transparency for customers in practice. Specifically:

- it presumes that the customer knows their consumption level and is also aware of which distribution zone they are in. As we have noted previously, our experience is that customers are not informed to such an extent. Their consumption will also change over time

- it further presumes that customers will be able to translate consumption levels into corresponding bill amounts using pricing parameters in the Commission's determinations

- as the Commission has foreshadowed, and anticipated in the Order, actual bills paid by customers will vary from prescribed or estimated annual bill amounts, giving rise for the need to refund amounts to customers and fuelling concerns that retailers have purposefully overcharged them. (Tracking any over-recovery of bill amounts for individual customers and monitoring compliance at this level would be involve considerable effort)

- any difference in the price control approach between flat and non-flat standing offers would be very difficult to explain, noting there are already challenges in explaining basic aspects of retail price regulation to the general public[7]

- under the Commission's "range" approach, annual reference consumption values are still required to calculate the 'estimated annual cost' for use when making discounted offers under clause 15(4)(b) and Schedule 3. It seems likely that these values would remain as specified in the Order. Customers and retailers will be most familiar with these reference values, and generating different values or approaches for standing offer compliance purposes will add complexity and confusion.

Overall in regulating non-flat VDO tariffs, we consider stakeholders would be more readily able to understand prices that are directly prescribed in Commission determinations. Customers are further likely to place trust in these values than alternatives generated by retailers under an opaque maximum bill approach.

The Order accommodates prescribed prices for non-flat tariffs

Under the Order the Commission must base the maximum bill amount for non-flat VDO tariffs on the flat tariff VDO, as well as the prescribed customer's electricity usage. We do not consider that clause 12(5)(b) requires the maximum bill be calculated using the "particular" customer's electricity consumption, which the Commission appears to have concluded in preferring an approach that accommodates all consumption values.[8]

[7] https://www.2gb.com/callers-slam-australian-energy-regulator-boss-for-clear-as-mud-explanation/
[8] Essential Services Commission, July 2019, p. 22.

We consider that, while it involves some judgement, the variable components of non-flat VDO tariffs can be informed by examining how different network tariffs affect the Commission's cost stack calculation. For example, all variable components could be assumed to apply equally to peak and off-peak periods, with final tariffs reflecting only the differences in the peak and off-peak network tariff components. The Commission may wish to explore how other variable costs (e.g. wholesale) are recovered differently by retailers in peak and off-peak periods. Prices for fixed tariff components could be identical to the flat tariff VDO in accordance with clause 12(5)(a). Corresponding usage rates for non-flat components can be similarly 'based on' prescribed customer usage profiles under clause 15(5)(b). Prices and quantities for non-flat tariffs used to calculate maximum bills for compliance purposes can be determined under clause 10(2)(c). The combination of prescribed prices and quantities for non-flat tariffs to generate a maximum bill can be prescribed in the same way as estimated annual costs are calculated for reference pricing purposes in Schedule 3 of the Order.

Other differences between flat and non-flat tariffs should be accommodated

While not explicitly stated in the Commission's issues paper, there appears to be a presumption that the maximum annual bill would be the same value for flat and non-flat VDO tariffs when using the same total annual consumption.[9] However, the efficient costs involved in supplying flat and non-flat customers is unlikely to be the same. Indeed, the rationale for introducing non-flat tariffs is to encourage more efficient electricity usage and ultimately lower the total cost of supply to customers. A customer's response to pricing structures, in terms of shifting consumption into cheaper periods, is a further reason why flat and non-flat maximum bills might be different. The Commission should validate this though calculating a 'bottom up' cost stack for non-flat tariffs as outlined above and applying this to benchmark consumption profiles for each tariff type.

Furthermore, and noting this may be outside of the Commission's scope, the introduction of non-flat VDO tariffs should be accompanied by a change in requirements such that these tariffs become the point of reference in offering discounted non-flat market offers. Calculating discounts for non-flat market offers in relation to the flat VDO is potentially misleading for customers given the likely underlying difference in costs and bills between flat and non-flat tariffs as previously outlined.

The Commission should provide for generic pass through events

Under clause 13(2) of the Order the Commission's determinations should adopt a framework for dealing with price variations that involves specifying known or likely events with uncertain timing but also accommodates unknown events.

Known events would give retailers some certainty that costs would be recovered, such as those associated with the triggering of the retailer reliability obligation. We understand this is something the Commission is monitoring[10] and our expectation is that Frontier's modelling approach would eventually require amendment to accommodate retailer obligations.

[9] ibid, pp. 22-4.
[10] ibid, p. 61.

Unknown events could be accommodated as per the non-exclusive list of "special circumstances" in arrangements administered previously by IPART.[11] These were exercised by ActewAGL in the case of material changes in gas costs[12] and provide an example for the Commission in terms of administering a simplified pass through process.

We would not support attempts to comprehensively list all possible trigger events as occurs in other frameworks (see for example under Rule 6.6 of the National Electricity Rules). The Commission's price determinations will not span multiple years and overly prescriptive approaches are more likely to spark unproductive stakeholder debate at the time of each determination without any corresponding benefit to customers.

Price regulation of embedded networks should only follow policy reviews

The Commission can now formulate a maximum price for embedded networks under clause 25A of the General Exemption Order. We note that the Victorian Government intends that this would be implemented on or before 1 July 2020[13], however the General Exemption Order does not compel the Commission to meet this or any other timeframe. Our view is that any consideration of price regulation should only take place after the completion of current and expected policy reviews.

Even then, we would only support the Commission adopting a simple, light-handed approach for setting maximum prices. We do not support the Commission spending resources in exploring the costs involved in supplying customers in embedded networks as they are unlikely to be materially different from other mass market retail customers.

We share the concerns that customers in embedded networks face real barriers in accessing the retail market and in accessing other consumer protections, and could be worse off as a result. The Commission has recently extended many protections to embedded network customers via changes to the Energy Retail Code which came into effect in January this year.

As the Commission is aware, the AEMC has developed a further significant package of reforms that aim to address barriers to competition and extend more protections under the National Energy Consumer Framework to customers in embedded networks.[14] The AEMC has indicated that where barriers to competition are removed, prices will not be regulated under the new framework. Any price regulation under this new framework would be a transitory measure and for legacy networks that do move into the new framework.

We support these reforms and are urging the Victorian Government to adopt them. We understand that the Government's commitment to "ban" embedded networks in new-build residential apartment blocks[15], and any associated policy review, will be directed at the same objective of increasing retail competition and consumer protections for embedded network customers. We have concerns that the Government will diverge (again) from national frameworks when there is a common objective and a strong case

[11] See for example, IPART, *Regulated gas retail tariffs and charges for small customers 2007 to 2010 - Gas - Final Report and Voluntary Transitional Pricing Arrangements*, June 2007, pp. 12-13.

[12] IPART, *ActewAGL's 2008 application for a special circumstances price increase - Gas — Final Decision and statement of reasons*, March 2008.

[13] Victorian Government, *Victorian Default Offer - Final Orders - Explanatory Statement*, May 2019, p. 7.

[14] https://www.aemc.gov.au/market-reviews-advice/updating-regulatory-frameworks-embedded-networks

[15] https://www.energy.vic.gov.au/victoriandefaultoffer

for harmonisation. There is a risk that further divergence may deliver worse outcomes by increasing real (and efficient) costs of retailing in Victoria.

The Commission should consider its task under clause 25A of the General Exemption Order after the Victorian Government has clarified its policy intentions and scope of associated changes to embedded networks.

Implementation of the VDO can be more effective and less burdensome

There are several other matters for the Commission's attention which potentially require changes to the Order or to legislation, however some could be addressed in amendments to the Energy Retail Code, including as envisaged under clause 16 of the Order:

- the recent Order made under section 35(3B) of the Electricity Industry Act extends the timeframe for retailers to publish compliant standing offer tariffs by now requiring only 2 weeks' notice. The Government noted it would further consider changes to publication and gazettal requirements.[16] We reiterate that gazettal requirement is redundant and this adds unnecessary cost and effort for retailers at a time where we are burdened with other requirements involving customer notifications

- the Commission could alleviate some of this effort by amending the Code so that advance notification of price or benefit changes (clause 70L) is not required when there is a change to standing offer tariffs, including VDO tariffs. This change could be made by amending Division 3 (which incorporates 70L) to apply only to 'market retail contracts' rather than to 'customer retail contracts' (the latter encompasses both standing and market offers). The 'benefits' portion of Division 3 is redundant for standing offers in any case

- notwithstanding the requirement of clause 15(2) of the Order, we consider it is not in the interest of customers for retailers to only use a reference price where a market offer is made on the basis of a discount. That is, retailers are able to circumvent this requirement which undermines the value of the VDO as a reference price

- as is permissible with the Default Market Offer, and of benefit to customers, our preference would be to use a customer's historic or estimated consumption in complying with the requirements of clause 15, rather than the annual reference consumption

- as some retailers have noted previously, billing systems typically manage pricing data in GST-exclusive terms. It would streamline compliance efforts if the Commission were to specify VDO prices in such terms, alongside equivalent GST-inclusive terms for those retailers with different billing arrangements or to align with the Commission's customer-facing reforms.

[16] Victorian Government, *Victorian Default Offer - Final Orders - Explanatory Statement*, May 2019, p. 10.