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30 January 2023

Essential Services Commission of Victoria
Lodged electronically: VDO@esc.vic.gov.au

Victorian Default Offer 2023-24 – 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.

EnergyAustralia appreciates the opportunity to provide this submission to the Essential Services Commission's (ESC) Consultation Paper on the Victorian Default Offer 2023-24. This submission focusses on the following key issues:

1. Changes to the escalation of Retail Operating Cost (ROC) and CARC by CPI and any other changes to the approach to ROC, which we oppose in favour of retaining regulatory consistency. The current CPI approach is effective and best practice, and the ESC's identified alternatives do not offer a stronger approach.
2. An additional allowance in the VDO for CDR implementation cost. We now provide updated implementation cost information in revised forecasts (incorporating actual spend to date), and new ongoing cost information.
3. A provision in the VDO for anticipated increases in bad debt for 2023-24, due to higher energy bills and economy wide cost of living pressures.
4. A wholesale cost methodology issue. The VDO should provision for the cost recovery of higher hedging cost, mainly concerning higher margining requirements in the ASX, as flagged by the Australian Competition and Consumer Commission (ACCC) in its *Inquiry into the National Electricity Market November 2022 Report* (ACCC report). Unlike the DMO, the VDO does not appear to provision for the funding of these margin requirements at all.

These issues are discussed in detail below.

1. Retail operating cost and escalation by CPI

The ESC discusses alternatives to its current Retail Operating Cost approach, and alternatives to using CPI for escalation of both Retail Operation Cost and Customer acquisition and retention costs (CARC) allowances in the VDO. The ESC describes the alternatives as:

(i) Use cost data collected from Retailers to set Retail Operating Costs, or to estimate the escalation factor year on year.
(ii) Use a different index, e.g. wage price index
(iii) Use a basket of indexes
(iv) Use another regulator's benchmark.

We firmly recommend that the ESC not adopt these alternatives and maintain a consistent approach to setting the Retail Operating cost and escalation by CPI. This would be pivotal to meeting the ESC's objectives on this issue to choose a solution that is efficient, accurate, transparent, simple and stable. We list our reasons below.

1.1. Maintaining consistency with current ROC and CPI approach is important, and current approach is effective

There is no evidence that the current approach is not working and does not reasonably reflect Retailer's actual costs, or that it is not aligned with other regulatory benchmarks.

With regard to Retail Operating costs, setting Retail Operating costs in line with another regulator's benchmark (the 2017 ICRC decision updated for CPI) with cross checks using Retailer data submitted to the ESC, is a workable and effective approach. It has the benefits of using two sources of data, and also avoids the administrative burden of the ESC determining a methodology for calculating Retail Operating Cost using Retailer data. That process would be highly complex, and involve deciding on complex issues like allocation of common costs, weighting different Retailers' data etc.

We point to three proof points that the current approach is effective and working well.

Firstly, as the ESC noted in its last VDO decision, its Retail Operating Cost allowance sits within "the range of (median) Retail Operating Costs" reported by Retailers in recent years.[1]

We ask:

- Does the escalation by CPI move the VDO Retail Operating Cost allowance outside a reasonable range of Retail Operating Costs reported by Retailers (this range should be wider than the median)? We anticipate that CPI of around 7% is unlikely to do so, and therefore recommend that the ESC not move away from its CPI approach.
- To verify whether CPI is a reasonable approach, the ESC could also check if the change in the median ROC reported by Retailers has tracked in line with CPI previously, as well as change in the average Retail Operating Cost.
- For more transparency on what the VDO sitting within "the range of (median) Retail Operating Costs" means, and what checks the ESC does against Retailer data.

Secondly, comparison of the VDO's Retail Operating Cost to the DMO's is also a useful exercise. Using the most recent decisions, in comparison to the DMO which uses one amount covering Retail Operating Cost and CARC:

- The VDO broadly aligns for residential customers (it's only $13-14 higher),
- but sits significantly lower for small business customers in NSW ($63-64 below).[2]

This shows that the VDO (which only sets the one amount for Residential and small business customers) is reasonably in line with the DMO for residential customers for Retail Operating Cost and CARC allowances (8% above), but actually results in an under-recovery for small business customers (by -25%). Any changes to the Retail Operating Cost and CARC approach which would result in a lower allowance (including moving away from CPI this year) would exacerbate this under-recovery for Retailers. This is yet another reason for the ESC to maintain consistency in setting both the Retail Operating Cost and CPI escalation.

Thirdly, comparing EnergyAustralia's latest Retail Operating Cost data submitted to the ESC for 2021-22 against the VDO for that time[3], [
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[1] FD - Victorian Default Offer 2022-23 - Final decision - 20220524_0 (7).pdf , p 25

[2] VDO 2022-23 had a ROC and CARC of $187 ($146 + $41), vs the DMO ROC and CARC (excl advanced meter costs) of $173 (residential) and $251 (small business).

[3] Victorian Default Offer amendment to price determination 2021, 14 July 2021

[4]

Further, on CPI escalation, it is also important to contextualise the high CPI in 2022-23. This surge in CPI is attributable to global supply-side issues and strong demand. The RBA has stated that as those issues resolve, and there are declines in commodity prices and slower growth in demand as economies face recessionary pressures, inflation and CPI will ease. Medium-term inflation forecasts will normalise dropping to 4.75% over 2023, and then a little above 3 per cent in 2024. We urge the ESC to resist changing the CPI benchmark in response to what is a temporary anomaly that will subside in two years.[5]

As further context against the entire VDO cost stack, we ask the ESC to compare any alternative to CPI escalation and assess how much it would change the overall level of the VDO. Any effect would likely be small – given that Retail Operating Cost and CARC (to which CPI is applied) is only 13% of the total VDO price for residential customers and 3% of the small business VDO.[6] The difference between 7% and 3% escalation is immaterial - 0.5% of the total annual residential VDO and 0.1% of the small business VDO.

Lastly, we recognise CPI escalation is an imperfect index for both ROC and CARC, but equally, so is any other index. The benefit in maintaining consistency is that any under or over recovery against actual cost over time is likely to be balanced over the longer term, including across periods of deflation such as during some quarters in the pandemic.

1.2. Alternatives to CPI escalation are not stronger options

We explore the alternatives to CPI escalation below, concluding that CPI is the strongest approach.

1.2.1. Use cost data collected from Retailers to estimate the escalation factor year on year

We acknowledge this could theoretically be a suitable alternative. However, as the AEMC observed in its *Best Practice Retail Price Regulation - Final Report*, this approach is problematic because it would be:

- "difficult to determine a mechanism for forecasting the index". i.e. the data will be backwards looking, it will provide the delta increase between previous years, but the ESC will still have to determine a forecast going forward. Forecasting from previous years is questionable because previous changes year on year are irrelevant and not a good predictor as to what might happen in the future. That is, cost drivers in Retail Operating Cost are multi-layered and complex, caused by new regulatory changes that need to be implemented, and cycles in technology improvements etc.
- "administratively complex and expensive"; and therefore lacks the ESC's objectives of transparency and simplicity.

1.2.2. Use a different index, e.g. wage price index

The ESC is considering using a different index such as the wage price index instead of CPI. This would produce an escalation of just over 3% based on the latest September wage index information published by the ABS. We disagree with this change because:

- The ESC's main reason seems to be that wages or labour "make up the largest share of ROC". However, our data reported to the ESC and ACCC does not reflect this. Across all customers, labour makes up only [].[7] Adopting a benchmark that uses the wage price index will fail to reflect non-labour costs, and potentially result in an allowance that is not reflective of efficient costs, and potentially an under-recovery for Retailers.

- Wage index and CPI might move in opposite directions, and therefore produce outcomes that are out of step with customer expectations and are not simple to understand. This is

[5] Statement by Philip Lowe, Governor: Monetary Policy Decision | Media Releases | RBA, November 2022
[6] Based off the 2022-23 VDO inclusive of GST.
[7] Based on EnergyAustralia's 2021-22 cost reporting to the ESC.

especially the case when CPI is decreasing, customers may expect that their energy bills should be reducing as well. Predictability, along with stability, is an important consideration.

1.2.3. Use a basket of indexes or another regulator's benchmark

It is not clear what basket of indexes would be used as an alternative to CPI, potentially a blend of both CPI and the wage price index, based on the split of labour vs non-labour costs reported by Retailers. We doubt this will provide any improvements in accuracy which will be outweighed by the problems of moving away from a consistent and stable approach across VDO determinations.

If the ESC is exploring the use of an alternative regulator's benchmark for Retail Operating Cost (other than ICRC's previous determination), we highlight using the ACCC's data would result in significantly higher Retail Operating Cost (and CARC) if the ACCC's data is used for small businesses in NSW. We also lack confidence in using the ACCC data to set the Retail Operating Cost in the DMO, given the lack of transparency in how the ACCC has interpreted Retailer data and how the averaged figure is produced. In particular, there is a lack of transparency over whether the Retail Operating Cost includes costs associated with regulatory changes (the AER states that it is supposed to, however this depends on how Retailers are submitting their data). The ESC's approach of individually assessing new regulatory costs has been transparent and provided assurance to industry that these efficient costs are being allowed for under the VDO.

1.3. CPI is the best practice approach to escalation

Our last reason to maintain the CPI escalation is that it would be in accordance with the AEMC's best practice advice on escalating ROC:

> "The CPI may not result in a totally cost efficient outcome since it represents a typical basket of consumer goods. However, the CPI is the most well understood index and so its use would promote transparency.
>
> Moreover, regulators currently use CPI to escalate retail operating costs, and so have experience in doing so. This maintains predictability and stability in the approach used to escalate retail operating costs, as well as minimising the administrative burden for the regulator [stability also being a key consideration for the ESC]. We consider escalating retail operating costs by **CPI is the best approach to use**."[8] (*Emphasis added*)

The ESC could also consider variations to the CPI approach such as taking a longer term average of CPI to smooth out the higher inflation in 2022 and 2023. Or, as above, adopt a blend of CPI and wage price index. However this would undermine the stability of the current approach and the ESC would also need to be prepared to apply this permanently, even where wage growth is trending upwards as it has in the past.

2. CDR

We refer to our submission to the last VDO for reasons as to why using Treasury's early estimates of CDR costs would grossly understate the cost of implementing the CDR. Mainly, the estimates were done at a very early stage and pre-dated a fundamental change in the data access model which reallocated responsibilities from AEMO to Retailers, increasing cost.[9] The VDO methodology should use CDR cost data submitted by Retailers.

[8] Microsoft Word - Best Practice Retail Price Regulation - Final Report - EMO0027 - 26 September 2013 - EMBARGOED (aemc.gov.au) , p 62

[9] EnergyAustralia.PDF (esc.vic.gov.au)

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3. Bad debt

We anticipate increases in bad debt in 2023-24 above our base levels, which should be reflected in the VDO, similar to the bad debt allowance for the pandemic. [

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Additionally, bad debt (which is a percentage of revenue) will increase because revenue for 2023-24 is forecast to be higher (due to retail price rises to reflect cost increases).

4. Wholesale cost issues

4.1. Increased cost of hedging

The ACCC's recent *Inquiry into the National Electricity Market November 2022 Report* recommended that the DMO and VDO should reflect higher hedging cost because hedging costs have escalated due to:

- the shift in contracting away from the ASX and towards over-the-counter contracts by some Retailers, and over-the-counter swap contracts, in general, trading at a premium to ASX swaps in 2022 for the 2023-24 period.

- the significantly increased cost of margining and collateral for most Retailers, particularly for ASX trading.[10]

Our focus is on the second point. We concur with the ACCC's view and submit the ESC should review its wholesale cost methodology to ensure these higher prudential requirements are reflected in the VDO for 2023-24.

Unlike the DMO which provides for some allowance for ASX *initial* margining requirements (albeit not variation margins), the VDO's wholesale cost methodology (as per Frontier's previous reports) does not appear to provide for any margining requirements. This is a significant gap given these margining requirements have increased exponentially in 2022 as forward contract values have increased and the ASX has sought more margin to cover the greater risk of default by counterparties.

While the impact has been on contract sellers (generators) throughout 2022, as forward contract values decrease, we expect a significant impact on contract buyers (Retailers) in the opposite direction, which should be recognised in the VDO.
The ESC could look to the DMO's methodology for margining requirements as a starting point. The DMO provides for hedge margining costs by:

> "ACIL Allen relies on the futures market to determine hedging costs. The futures market includes prudential obligations by requiring entities to lodge initial margins (we assume cash) when contracts are purchased or sold. We understand that the cash that is lodged as an initial margin receives a money market related return which offsets some of the funding costs. The assumed money market rate is 0.10 per cent. Additional margin calls may apply where contracts move unfavourably for the purchaser or seller. However, as these may be favourable or unfavourable, we have assumed that they average out over time.
>
> We understand that the initial margin is set based on three parameters being:
> — the price scanning range (PSR) expressed as a percentage of the contract face value and is set for each of the base, peak and cap contract types
> — the intra monthly spread charge and is set for each of the base, peak and cap contract types
> — the spot isolation rate and is set for each of the base, peak and cap contract types.
>
> Using the annual average futures price and applying the above factors gives an average initial margin for each quarter. This is divided by the average hours in the given quarter.

[10] p 65

> Then applying an assumed funding cost but adjusted for an assumed return on cash lodged with the clearing results in the prudential cost per MWh for each contract type."[11]

This appears to reasonably address initial margins i.e. the amount a trader must deposit with the ASX when first trading to cover default risk. However, it does not address variation margins which must be paid to be able to continue trading, when there are unfavourable changes in the current market value of the futures contract.

For sellers of contracts (generators) contract values increased substantially throughout 2022, compared to what they were originally sold for. EnergyAustralia revalued its sold contracts (fair value movements) as a negative impact on earnings in H1 2022 at $2031 million before tax. This translated into increased requirements to post additional variation margin to ASX. [

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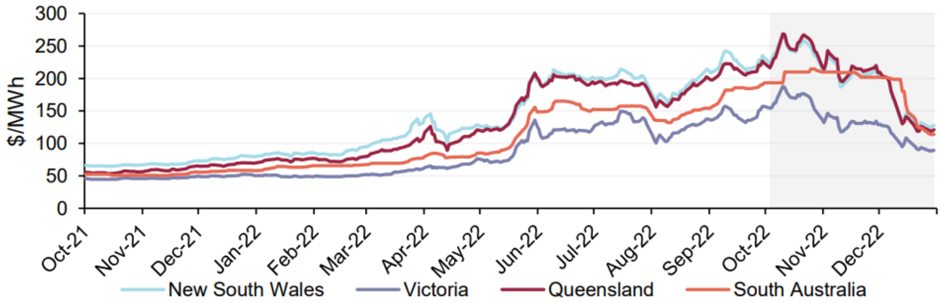
The 2022 variation margins mostly affected our generation business so we would not seek a provision for it in the VDO. However, if forward contract prices continue to fall in 2023-24, which has already happened following government announcements of price intervention (see graph below), these decreases in forward contract values will inversely impact buyers (Retailers) (contract values worth less than what they were bought at), requiring significant amounts of variation margin to be posted by Retailers.

Figure 21 Cal23 Futures trended upwards through October, then declined rapidly from November

ASX Energy – daily Cal 2023 base futures by region



Source: AEMO quarterly report.[12]

The VDO (and DMO) should provide an allowance for the cost of capital needed to fund this variation margin for retailers (and the VDO should also provide for the cost of funding initial margins as well). As above, ACIL Allen notes that these variations can be favourable and unfavourable and so they average out, however this may be overly simplistic. While this approach may have been acceptable where contract values were fairly stable in the past (and variation margin calls not large), it should be revisited for current market conditions. There is also an asymmetric impact, the downside impact of unfavourable movements is far greater with the real risk of insolvency/RoLR processes, versus receiving payments when movements are favourable (which won't necessarily be kept for the future).

4.2. Market intervention costs

We support the ESC's proposed approach regarding Market intervention costs. For additional costs determined after the final VDO 2023-24 is made, we would support a reopener ahead of the next VDO if the costs are material, 5% or above of the annual VDO price.

[11] Report (aer.gov.au), p 24-25
[12] qed-q4-2022.pdf (aemo.com.au)

5. Future VDO consultation process

We agree with the ESC not publishing a VDO Consultation Paper, if there are no material changes to the pricing methodology, but the ESC should still accept submissions ahead of their draft decision so that Retailers can proactively raise issues. EnergyAustralia has proactively raised a few issues in the last two VDO processes which resulted in positive changes to the VDO so we see merit in this process.

If the ESC proposes material changes to the VDO price methodology, they should publish a consultation paper outlining their proposals.

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

Yours sincerely,

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