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Victorian Default Offer 2021
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20 October 2020

Victorian Default Offer 2021 – draft decision

AGL would like to take this opportunity to respond to the *Victorian Default Offer 2021 – draft decision* (Draft Decision) released by the Essential Service Commission (ESC) on the 15 September 2020.

The introduction of the Victorian Default Offer (VDO) on 1 January 2019 re-introduced regulated pricing to the Victorian retail electricity market so the setting of VDO prices is a critical process if this market is to remain competitive.

AGL is generally supportive of the Draft Decision as it follows the same methodology used by the ESC in determining both the 2019 and 2020 VDO prices. This provides some certainty for industry participants. AGL does believe that further consideration is warranted by the ESC on components such as the cost of environmental schemes and the retail operating cost benchmark.

Most importantly, AGL has significant concerns with how the ESC has chosen to apply several new considerations in the Draft Decision, namely:

- the proposed 12-month length of the VDO determination period, given the Victorian Government has changed the regulatory pricing period for electricity networks to financial years starting from July 2021; and
- providing no allowance for the impact of COVID-19 to retail businesses.

Under the pricing order, the ESC must make a new determination for VDO prices to apply from 1 January 2021 but can determine a period of more or less than 12 months.

AGL believes this decision should be based on two fundamental principles:

1. aligning the determination of VDO prices with the determination of network prices as quickly as possible; and
2. avoiding a VDO determination period of greater than 12 months, given the higher level of uncertainty and the greater risk that any forecasts made at this time will be in error.

As noted by the ESC in its Draft Decision, almost every stakeholder supported applying the 2021 VDO for only a six-month regulatory period from 1 January to 30 June 2021 to allow subsequent VDO determinations to align with network price changes from that point.

However, the ESC has initially proposed a 12-month period because it will not have final approved network prices to include in a VDO determination commencing 1 July 2021.

AGL accepts this is an issue but does not agree with the ESC delaying resolving the timing problems until a 2022 VDO determination. Instead, AGL fully supports the ESC making another VDO pricing determination as soon as is practicable after 1 July 2021 to align the VDO with the network charges that will apply at that time. This would mean in practice that this 2021 VDO will apply for 7 or 8 months with a further VDO to be made next year that will apply until 30 June 2022.

AGL also urges the ESC to include an initial allowance for the impact of COVID-19 in this 2021 VDO price determination. We recognise that it is difficult to estimate the full impact of COVID-19 at this point but conservative estimates of its impact on bad debts are readily available. AGL believes it would be prudent to include an estimated cost in this 2021 VDO as:

- given the substantial reductions in network and wholesale costs, the costs of COVID-19 can start to be recovered with no discernible impact on customers;
- if the determination period is set at 7 or 8 months then the ESC can review this allowance in the next VDO determination when further data is available; and
- to ignore the costs of COVID-19 until further data is available will allow the impacts to accumulate with the eventual recovery of costs creating a step increase in VDO prices to the detriment of customers.

Further concerns and comments in response to the Draft Decision are detailed in Attachment A.

If you have any questions in relation to this submission, please contact me on (03) 8633 6207 or Patrick Whish-Wilson on (02) 9921 2207.

Yours sincerely

Elizabeth Molyneux
GM of Policy and Market Regulation

Attachment A: AGL Responses to the ESC Draft Decision

Wholesale electricity costs

AGL generally supports the Frontier's method for estimating wholesale electricity cost given the requirements placed on the ESC and that the approach is consistent with for the 2020 VDO price determination.

AGL has analysed the load shapes for Victoria over this period and agrees with Frontier that the pandemic has impacted electricity consumption but it is uncertain at this stage and not possible to identify a consistent change in consumption patterns that would warrant further adjustments.

AGL believes that Frontier should re-examine whether its use of the contract premium in the scaling of each Monte Carlo simulation is justifiable. A significant proportion of energy is now being procured through Power Purchasing Agreements (PPAs) and AGL expects that if this contract premium still exists it would be below the current 5 per cent estimate used by Frontier. AGL believes this premium is likely to reduce further, and potentially reverse, as demand for derivative contracts decreases.

Network costs

Network costs are a significant component of electricity supply and must be accurately reflected in VDO prices.

The Victorian Government has moved the calendar year regulatory period for the Victorian distribution networks to a financial year basis, extending the current 5-year regulatory period by six months to 30 June 2021. We note the Victorian networks have submitted their proposed network tariffs to the AER for the first six months of 2021 and that these should be approved by mid-November 2020 and can be incorporated into the final VDO determination.

The remaining question for AGL is the treatment of the change in network tariffs that will apply from 1 July 2021. As highlighted, AGL strongly supports the ESC making a further VDO pricing determination in 2021 that will align with these networks tariffs changes. The ESC believes it cannot make a VDO determination for 1 July 2021 because the AER will not approve new network tariffs until June 2021. AGL would accept a VDO price determination that applies as soon as is feasible after these network tariffs are approved.

AGL does not support the ESC's current proposal for a 12-month period with a cost passthrough for material changes to network prices during 2021. If the ESC chooses to persist with this approach then the ESC must apply a mandatory pass-through rather than any subjective materiality test as network tariffs are likely to increase from 1 July 2021 and need to be accounted for in the VDO as soon as practicable.

Environmental schemes and other regulatory costs

Large-scale renewable energy target (LRET)

The ESC has retained its market price approach to calculating the cost of complying with the large-scale renewable energy target (LRET).

AGL and other retailers have consistently highlighted that basing the cost of the LRET only on LGC market prices is no longer appropriate as only a small percentage of LGCs are traded on the spot market and these prices are often not reflective of a retailers' underlying and historic cost of procuring LGC certificates.

While recognising the difficulties for the ESC in using PPA prices to estimate the costs of complying with the LRET, AGL remains concerned that the price of LGCs can fluctuate greatly in such a thinly traded market and the ESC's current market approach could result in unrealistic and commercially damaging outcomes.

AGL suggest another option to mitigate this scenario is for the ESC to apply a minimum price to its market price approach (if the LGC price fell below the floor price then the ESC would use the floor price in its calculations). This would ensure that in instances of price volatility where LGC prices fall to unrealistic levels (compared to retailers' underlying costs), it does not unduly impact the estimation of the LRET allowance under the VDO.

A potential approach to estimating the floor on LGC prices is to use the Australian Carbon Credit Unit (ACCU) certificate price adjusted by the NEM emissions intensity factor. ACCU's are created by quality carbon abatement projects and generally provide a reasonable proxy for the cost of carbon abatement more generally in the economy. This would be updated at the same time as the market- based price is calculated.

Using the ACCU spot price of $15.85 and an emission factor for H1 2020 of 0.7264 tCO2-e/MW hr from the Clean Energy Regulator (CER) in their Quarterly Carbon Market Report [1] would produce a cost estimate for abating carbon in the NEM of $11.50 per certificate. AGL would propose this provides a reasonable floor price to LGCs in the future if the ESC is not willing to explore other options for calculating the actual efficient cost of providing LGCs over the scheme life.

A further issue for the ESC to consider for 2021 is the renewable power percentage (RRP) used in its modelling. As acknowledged by Frontier, the derivation of the default RPP assumes that liable acquisitions remain constant year on year and if there is demand growth there is the potential for overestimating the RPP. The converse is also true. A reduction in demand would lead to the RPP being understated and that is likely the situation for 2021, as published by AEMO in the 2020 Electricity Statement of Opportunities (ESOO)[2].

AGL believes it is prudent for the ESC to adjust the RPP accordingly for the 2021 calendar year.

Small-scale Renewable Energy Scheme (SRES)

The Small-scale Technology Percentage (STP) is determined by the CER based on estimates of the:

- number of STCs that will be created for the year;
- amount of electricity that will be acquired for the year; and
- number of partial exemptions expected to be claimed for the year

In the Draft Decision, the ESC has chosen to use the midpoint of the 2021 non-binding STP and the 2020 binding STP to calculate the cost of the SRES in 2021. This is a more reasonable methodology than simply relying on the non-binding STP given it has been consistently underestimated in previous years.

The CER has set a higher non-binding STP for 2021[3] due to higher than expected roof-top solar uptake but it is important to note that it has assumed future energy demand is flat. As highlighted above on LRET, AEMO is expecting a reduction in energy demand in the 2020 ESOO and this needs to be considered. AGL recommends the ESC adjust the 2021 non-binding STP to account for the expected and identified change in energy demand before using its mid-point methodology.

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[1] http://www.cleanenergyregulator.gov.au/DocumentAssets/Documents/QCMR%20June%20Quarter%202020.pdf
[2] https://aemo.com.au/-/media/files/electricity/nem/planning_and_forecasting/nem_esoo/2020/2020-electricity-statement-of-opportunities.pdf?la=en&hash=85DC43733822F2B03B23518229C6F1B2, p30
[3] Clean Energy Regulator, Quarterly Carbon Market Report – June quarter 2020, p. 28.

Table 1: ESOO Demand Reduction

	Operational Demand (TWh)	Change	
		1-year	2-year
2018-19	183.8	-0.4%	
2019-20	180.9	-1.6%	-2.0%
2020-21	175.7	-2.9%	-4.4%

Source: AEMO

Victorian Energy Upgrades (VEU)

The ESC estimate of the average price per certificate is around $10 higher than the estimate used to for the 2020 VDO. This increase in costs is largely a result of the restrictions on many certificate generating activities due to the impact of COVID-19. AGL is concerned that this is unlikely to fully account for the cost of the VEU scheme in 2021 because the VEU target remains at the 2020 target level, COVID-19 restrictions continue to impact certificate generating activities and several activities are likely to be removed from the scheme during 2021, in particular the removal of industrial lighting.

Reliability and Emergency Reserve Trader costs

The Reliability and Emergency Reserve Trader (RERT) is a function conferred on AEMO to maintain power system reliability and system security and the cost is levied on market participants (including retailers) and therefore needs to be allowed for in the VDO prices.

The Draft Decision makes an allowance of $2.43 per customer but AGL maintains that this underestimates the cost of the RERT to domestic and small business customers.

RERT is called upon when the demand and supply balance is tight, and these situations are predominantly driven by periods of high demand which in turn are driven by the demand profile of mass-market customers. AEMO allocate these costs only based on annual consumption but AGL believes these should be allocated based on the share that mass-market demand contributes to total demand during the RERT periods.

Accordingly, AGL proposes that a significantly higher portion of the cost of the RERT should be attributed to mass-market customers in accord with their proportion of total demand when the RERT is utilised.

AEMO Directions

The Draft Decision acknowledges that:

> *"AGL also raised the cost of an AEMO direction in Victoria in the first quarter of 2020, with an estimated cost of $17.5 million. Without further detail about how retailers have been directly impacted by this direction we do not propose to allow for this cost in our draft decision but are investigating the matter further with AEMO."*

The recovery of costs of directions is clearly defined in section 3.15.8 of the National Electricity Rules (NER) with most of the costs recovered from Market Customers on an energy basis. AGL believes the ESC should account for these costs in its VDO determinations. The proportion of energy consumed by residential and business customers should be estimated (even at a customer class level) and used as the basis for customer recovery of directions costs.

Ancillary charges

Ancillary services are used by AEMO to manage the power system and are allocated on a regional basis and vary considerably from period to period. AGL supports the ESC's approach of analysing AEMO data to estimate Victorian specific ancillary charges for the regulatory period beginning 1 January 2021.

Retail operating costs

In its Draft Decision, the ESC has referred an AGL ASX announcement in claiming that, "*there is publicly available evidence that electricity retailers have achieved substantial savings in cost to serve in recent years, with further savings forecast*."[4]

The ESC has also requested information about total costs. AGL's financial statements for 2019-20 are publicly available but it is important to understand what these costs represent before drawing general conclusion about cost to serve:

- The costs referred to are total AGL Group operating costs, excluding depreciation and amortisation (D&A). These costs relate, not only to the retail business or Customer Markets, but also to AGL's Wholesale Markets, Group Operations and Centrally Managed Expenses. These costs are not readily comparable to the '*cost to serve'* considered within the VDO. These costs incorporate $135 million in savings as referred to in the Draft Decision but also one-off asset sales and business simplifications. Due to other cost increases, total operating costs (before D&A) has increased by 3.8 per cent from $1,548 million in 2018-19 to $1,607 million in 2019-20.
- These costs do not include D&A. Total D&A for the AGL Group has increased by over 20 per cent from $625 million in 2018-19 to $753 million in 2019-20[5]. This is partly due to the $300 million Customer Experience Transformation Program which was delivered in 2018-19. Expenditures on IT are amortised over a number of years and the resultant impact on D&A must be included in the ESC's analysis to recognise the significant costs of digital transformation and system upgrades.
- Total operating costs for the AGL Group, including D&A, increased from $2,173 million in 2018-19 to $2,360 million 2019-20. This is a significant increase of 8.6 per cent, noting that these costs include the impact of COVID-19.

AGL recommends that the ESC consider AGL's public statements in a more comprehensive manner and review a broader range of public information, including the financial statements in the Appendix 4E statement provided to the ASX. The presentation referred to by the ESC shows that overall total operating costs have increased, even after allowing for improved operational efficiency. Rather than inferring that there are substantial savings in cost to serve, the information provided in that presentation highlights real cost increases of over 8 per cent in the retail operating cost allowance that the ESC should consider.

AGL would also emphasise that the financial statements are prepared according to management structure. Caution is required when assessing these statements in isolation to other group costs, particularly, Centrally Managed Expenses. Centrally Managed Expenses represent corporate functions and other centralised operations, such IT, which are not re-allocated to the operating segments. In 2019-20, these costs including D&A increased by over 43 per cent.

[4] AGL, ASX announcement - FY20 Results Presentation, 13 August, p.24
[5] AGL, ASX announcement, Appendix 4E, 13 August 2020, p. 33

Impact of COVID-19 on retail costs

In its Draft Decision, the ESC indicated that there is insufficient justification to increase the retail operating cost benchmark due to the impacts of the pandemic on bad debt. In addition, the ESC stated that they have not received sufficient evidence to adjust the benchmarks for other costs arising from the pandemic.

While it is difficult to confidently estimate the impact of COVID-19 now, it does not mean that the costs do not exist and can be ignored. There is a degree of uncertainty with any forecast and all other parameters in the determination of the VDO are being forecast or modelled for 2021. For example, despite the volatility in the National Electricity Market and the uncertainty regarding the impacts of COVID-19, the ESC has elected to incorporate a 20 per cent reduction in wholesale energy costs as modelled by Frontier.

IPART's draft report on the performance of the NSW electricity market[6] noted that:

> *"COVID-19 has caused many electricity consumers to experience financial stress due to a combination of loss of income, increased energy use at home, and business closures. As a result, many consumers are having difficulty paying for their energy bills…*
>
> *COVID-19 has created risks for the ongoing financial viability of energy retailers. Energy retailing is a relatively low-margin industry and retailers bear the credit risk for the entire supply chain. The pandemic has resulted in energy retailers facing rising operating and debt expenses while revenues are falling. "*

AGL urges the ESC to make allowance for the impact of COVID-19 on retail costs and specifically, bad debts.

Impact of COVID-19 on bad debts

All businesses seek to avoid or reduce bad debt expense. However, due to the obligation to supply, bad debt expense is a cost which energy retailers must ultimately recover from other customers who can pay. The ESC is considering a variation mechanism to potentially adjust for COVID-19 costs, but it is unclear how such a mechanism would work.

IPART has observed:

> *"In August, the AER provided some observations from across the NEM indicating increases in the proportion of customers in electricity debt and the average electricity debt level. Increased debt is the result of two factors – increased residential demand (with more people spending more time at home) and a lower ability to pay (many have lost employment and are relying on government support). Reported debt levels may increase further during 2020-21, firstly because of the lag in billing data and secondly because government income subsidies will be reduced (and eligibility tightened) toward the end of 2020 which may further impact on ability to pay."*[7]

The AER has collected data from retailers which has shown significant increases in residential and small business debt[8]:

- Residential electricity debt outstanding more than 90 days has increased by around 40 per cent from $90 million in Q2 of 2019-20 (prior to COVID-19) to about $130 million in Q1 of 2020-21, and

[6] IPART, *Monitoring the electricity retail market 2019-2020*, Draft Report, September 2020, p. 2
[7] Ibid p. 7
[8] AER, *Retail market data dashboard* – 7 September 2020 – COVID-19

- Small business electricity debt outstanding more than 90 days has increased from less than $30 million in Q2 of 2019-20 to nearly $50 million in Q1 of 2020-21, an increase of around 60 per cent.

There is a high correlation between the level of debt, particularly 90+ days outstanding, and bad debt. The AER data excludes Victoria where the extended lockdown will prolong the elevated level of overdue debt.

The ESC has introduced new rules, *Supporting energy customers through the coronavirus pandemic* reform, which require retailers to provide support to small business customers from 1 October 2020 for six months, including payment plans and no disconnections. These additional requirements will lead to higher levels of debt in 2021. The ESC has referred to data showing increases in residential and business debt.[9]

In its Results Presentation, AGL disclosed that the impact of COVID-19 on AGL's 2019-20 results amounted to $38 million, comprising of $20 million in net bad debt expense and $18 million in increased on-site operating costs[10].

AGL has also provided an earnings guidance for 2020-21. This guidance is approved by the AGL Board and management and provides important information for investors on the company's outlook. This guidance is based on robust processes with detailed build-up of forecast revenue and costs across the business. This guidance forecast the expected credit loss, i.e. bad debt, due to the pandemic to be around $40 million. This will result in a level of bad debt equivalent to 2 per cent of revenue, compared with the underlying historic credit loss of 1.5 per cent[11], an increase of over 30 per cent. This cost is material and therefore specifically detailed in the public statement. While any estimate is uncertain, the actual cost could be higher, depending on economic conditions, and the length and breadth of the pandemic. This cost is expected to continue into calendar 2021 particularly in Victoria, due to the extended lockdown and billing cycle.

Based on AGL's actual bad debt expense in 2019-20 and averaging of the expense forecast over 2020-21, the financial impact of COVID-19 on AGL in 2020 will be around $10 per customer, after adjusting for Commercial and Industrial customer debt. This cost could not be predicted and therefore not allowed for in the 2020 VDO.

AGL has provided public information which can used to assess the likely bad debt in 2021. Although uncertain, there is a significant cost impact of COVID-19 and the ESC should explain how these costs will be recognised and accounted for. The ESC also needs to consider how to compensate for the unforeseen bad debts incurred in 2020, especially if it is considering adjusting for COVID-19 cost incurred in 2021 through a true-up mechanism.

Impact of COVID-19 on additional operating costs

In AGL's previous submission to the Consultation Paper, we noted that there are increases in operating costs including provision of office equipment, upgrades to IT and telecommunication capabilities as result of working from home arrangements. In addition, tasks have been taking longer and been more complicated, especially when third party providers are involved under the current circumstances.

In 2019-20, AGL has tracked the additional on-site cost due to COVID-19 at power generation sites to be $18 million. We have not accounted for these costs separately for the retail business but it is clear that there are many additional costs including compliance with the ESC's *Supporting energy customers through the coronavirus pandemic* reform and compliance with additional health guidelines.

[9] ESC, Media release – Regulator keeping watch on energy debt, 30 September 2020
[10] AGL, ASX announcement - FY20 Results Presentation, 13 August, p. 23
[11] Ibid, p.24

Productivity factor for retail costs

The ESC Draft Decision queries whether an annual productivity factor should be applied to retail operating costs.

AGL understand that in setting the revenue allowance for distribution networks, the AER considers a productivity factor in relation to operating and maintenance costs. Under these revenue determinations, the distribution networks are allowed to earn annual revenue amounts, with subsequent under and over adjustments.

Unlike distribution networks which are regulated monopolies, retailers do not have a guaranteed customer base. To maintain their customers, retailers have to ensure that prices are competitive.

Most retail operating costs such as contract centres, billing, debt collection and IT are fixed in the short term. With annual churn or switching rates in Victoria of over 20 per cent, a retailer's customer base fluctuates with any customer losses needed to be replaced by acquisitions as a loss of customers will result in a higher operating cost on a per customer basis. For example, if a retailer loses 5 per cent of its customers, its operating cost per customer will increase by around 5 per cent, since total costs are largely fixed.

In addition, the retail operating cost applied in the VDO is a benchmark and is not based on actual retailers' costs. The ESC notes that its data shows a range of retailers' actual operating costs that are above and below the benchmark. Highlighting that a single retailer may have improved its cost efficiency is irrelevant unless it can be demonstarted that the industry is managing productivity improvements.

In theory, AGL supports the principle of a productivity factor but does not consider it to be warranted in the current VDO determination when, in AGL's view, most of the uncertainty about the current benchmark is that it is insufficient given increased regulatory costs and impact of COVID-19.

Cost of complying with the five-minute settlement rule change

The ESC has acknowledged that the introduction of five-minute settlement (5MS) may lead to additional costs for retailers but require retailers to provide further information on cost changes to justify allowing for this cost in the retailing operating cost benchmark.

AEMO has completed a report which included estimated of the costs of implementing 5MS for industry participants and AEMO[12]:

- The 5MS program will have a significant impact on Participants, and in particular Market Customers (including retailers), Market Generators, and metering service providers, with total cost to Participants over 15 years from implementing Five-Minute Settlement expected to be $250 million, including system change costs of $150 million.
- AEMO has established a significant program to undertake the 5MS Program changes. AEMO has estimated that it will incur a cost of approximately $121 million over ten years as part of implementing and operating Five-Minute Settlement and Global Settlement.

AGL's forecast costs to comply with the 5MS program are provided in a confidential attachment. Almost all of these costs are implementation costs that will not be sustained but will need to be recovered over the short-term. Furthermore, there are no identifiable productivity improvements arising from the implementation of 5MS.

[12] AEMO, Declared NEM Project – 5MS Program, Final Report and Determination, November 2019, p 8-9

Retail Margin

While we generally support the ESC's proposal to maintain the retail operating margin based on previous regulatory decisions by Australian regulators, the allowance for retail operating margin is only valid if all the components of the cost stack are appropriately accounted for. If the additional costs due to COVID-19 are not considered, this will effectively result in a lower allowance for retail margin.

The unforeseen impact of COVID-19 in 2020 and the inability to adjust standing offer prices provides a demonstration of the risk of regulated pricing. In its Draft Decision, the ESC has not provided any allowance for COVID-19 costs because of uncertainty but this would require the ESC to revisit the retail margin benchmark to allow for the higher regulatory risk and increased risk profile faced by electricity retailers.

The ESC has also commented that there have been new applications for retail licences during the pandemic. In our view, it is more relevant to consider if new retailers are commencing operations. We note that at least one existing retailer has exited the retail energy market due to the "*risks associated with ongoing exposure to a challenging and changing regulatory environment and a potential COVID-19 related increase in bad debt*".[13]

The ESC has also compared the market offers with the VDO prices and noted that since median market offers have gone down, ""[I]if the profitability of retailers were threatened, due to the cost impact of the pandemic, we would expect the median market offer to go up". This view is too simplistic because:

- the median offer is not the only offer in the market, there are market offers higher than the median,
- changes in market offers reflect a number of factors particularly the movement in wholesale energy cost (WEC in the 2020 VDO was based on contract prices up to October 2019), and
- competitive and strategic factors are also important.

[13] amaysim, ASX announcement, 31 August 2020

Attachment B: CONFIDENTIAL Cost to implement 5MS