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14 December 2023

Default market offer prices 2024–25 request for comment paper

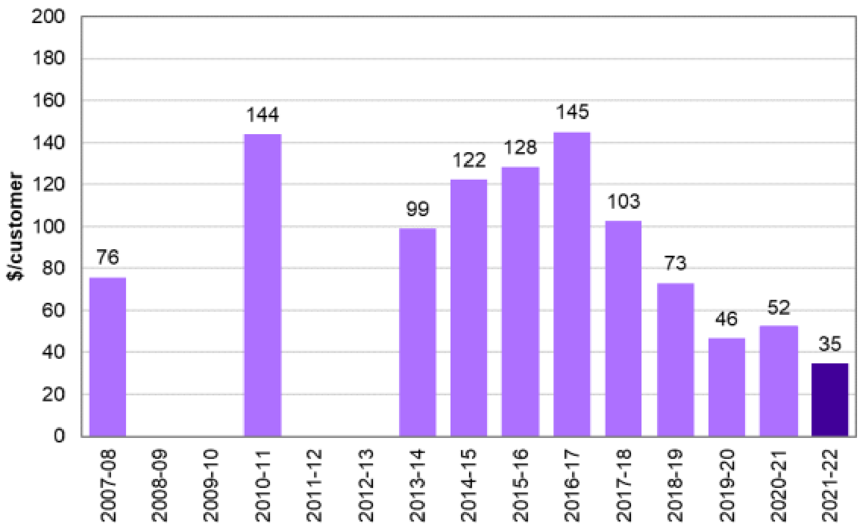
The Australian Energy Council ('AEC') welcomes the opportunity to make a submission on the Essential Service Commission's ('AER') *Victorian default offer 2024–25 request for comment paper.*

The AEC is the peak industry body for electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. AEC members generate and sell energy to over 10 million homes and businesses and are major investors in renewable energy generation. The AEC supports reaching net-zero by 2050 as well as a 55 per cent emissions reduction target by 2035 and is committed to delivering the energy transition for the benefit of consumers.

Retailers have been competing in a highly volatile and challenging environment as the below graph from the ACCC shows:[1]

Figure 4.5: Retail margins in 2021–22 declined to the lowest on record

Average retail margins (as earnings before interest, tax, depreciation and amortization or EBITDA) per residential customer across the NEM, 2007–08 to 2021–22, real $2021–22, excluding GST



Source: ACCC analysis based on retailers' data.

The AEC understands the balance the ESC needs to find when setting the VDO price, between protecting customers from unreasonably high prices and ensuring investors are compensated for the capital they provide retailers. The AEC considers that in recent years the retail market is becoming increasingly unattractive as a site for equity investment. The AEC notes the record levels of Retailer of Last Resort events over the last year and that as the Australian Energy Regulator (AER) noted in its *State of the Energy Market Report 2023*, the market remains vulnerable to supply or demand shocks:

[1] ACCC (2022) Inquiry into the National Electricity Market – November 2022 Report at https://www.accc.gov.au/about-us/publications/serial-publications/inquiry-into-the-national-electricity-market-2018-25/inquiry-into-the-national-electricity-market-november-2022-report p.73

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> *While wholesale prices have subsided since a peak in 2022, the market remains vulnerable to supply or demand shocks. Reliability issues with coal-fired generation assets and managing the increasingly peaky shape of customer demand could also put upward pressure on wholesale costs.*[2]

The AEC believes that it is important for the ESC to ensure that the VDO 2024 adequately supports the retail market investing environment.

The AEC addresses key consultation questions below.

Wholesale electricity costs

The AEC accepts that peak swap wholesale electricity futures contracts are now rarely traded. The AEC proposes that the ESC seek over-the-counter contract (OTC) prices from brokers and incorporate these into the modelling to estimate wholesale electricity costs.

In addition, the AEC encourages the ESC to monitor (for potential future material impacts) the following factors for consideration in the 2024-25 determination and beyond:

(i) **Impacts on settled load shape of unaccounted for energy (UFE):** As a body of trending data has become available since the implementation of global settlements, impacts of the 'true' NSLP shape on retailer hedging costs (up or down by network zone) may become apparent.

(ii) **Allowance for extreme market movements:** The AEC supports and acknowledges the ESC inclusion of a volatility allowance designed to compensate prudent retailers for the costs of holding sufficient working capital to remain financially viable through periods of peak demand and price. The AEC, however, notes that the current VDO methodology does not allow for working capital support for the type of extreme market scenario where, over an extended period of time, demand sits above the swap covered position simultaneous to prices landing above the WEC allowance. In such scenarios retailers incur negative margin over time. The AEC recommends the ESC monitor the prevalence of such scenarios and considers the cumulative negative margins retailers take on in such events.

Retail operating margin

The AEC notes that for the 2023–24 Victorian Default Offer, the ESC set the retail operating margin at 5.3 per cent based on benchmarks set by other regulators and having regard to the expected returns model. The AEC proposes that the ESC make explicit its assumptions in determining the 5.3%, so that there is more transparency about what EBITDA the ESC is targeting and how it makes its selection within the range of observed variables. With respect to the other regulators that the ESC uses, the AEC does not believe they are comparable market environments.

The AEC does not support the decision the ESC made to reduce the retail operating margin from 5.7 to 5.3 per cent, between the 2023-24 Victorian Default Offer Draft and Final decisions. In doing so, the ESC cited several reasons for this reduction:

- "since 2020, most retailers have offered market offers below, and sometimes well below, the Victorian Default Offer
- retail margins set by other regulators have decreased
- additional retailers have sought to enter the market
- 5.3 per cent is within the range of retail margins produced by the expected returns approach

[2] AER (2023) State of the Energy Market at https://www.aer.gov.au/publications/state-of-the-energy-market-reports/state-of-the-energy-market-2023 p.230

- on average, retailers' reported retail margins have decreased."[3]

The AEC notes the following responses to the ESC's arguments:

- the report that some retailers are offering market offers below the VDO is a somewhat circular argument as retailers are forced to lower their offers to compete effectively – the VDO has become an offer of choice for customers as the growth in customers on the VDO shows. This argument does also not account for the record low margins under which retailers are operating. There is a real question as to what sort of market outcome the ESC is targeting in terms of an adequate environment for retail market investment.
- with respect to the other regulators that the ESC uses, the AEC does not believe they are comparable market environments.
- while some new retailers have sought to enter the market in 2022 and 2023, there has been a higher proportion of exits and the entries have significantly declined since mid-2022.
- while 5.3 per cent is within the range of retail margins produced by the expected returns approach, it does not account for changes in the market environment including the high interest rate environment which has emerged as more than a short-term change. The AEC believes that the increase in financial cost should be reflected in the retail operating margin.

The AEC therefore proposes that the retail operating margin be set at 5.7 per cent for VDO 2024. Reinstatement demonstrates a return to standards upheld in previous reviews, which were long considered by the ESC to be appropriate.

Retail operating costs

The AEC encourages the ESC to monitor (for potential future material impacts) the following factors for consideration in the 2024-25 determination and beyond:

i. **Bundling of allowance for bad debts:** Bad debt expenditure is a function of the risk of customer default and the size of customer bills - in essence, a variable cost proportionate to retailer income. Bundling bad debt recoveries in with other ROC elements (which are logically applied as a cost per customer) imposes a cross subsidy whereby small customers are at risk of being overcharged to the benefit of larger consumers. As overall bill sizes increase, the AEC encourages the ESC to monitor the size of such cross-subsidy impacts and, if material, consider separating bad debts from ROC and then apply a percentage of income method to determine the bad debts element.

ii. **Weighting of retailer ROC data:** It is important that any regulated price still promotes industry competition and innovation. To this end, the AEC encourages the ESC to continue to monitor the gap between the ROC determined under the current customer weighted approach and the ROC reasonably expected for a start-up and prudent Tier 2 retailer.

Any questions about this submission should be addressed to Jo De Silva, General Manager Retail Policy by email to jo.desilva@energycouncil.com.au or by telephone on 03 9205 3100.

Yours sincerely,

Jo De Silva

Jo De Silva
General Manager Retail Policy

[3] ESC (2023) Victorian Default Offer 2023-24 Final Decision at https://www.esc.vic.gov.au/electricity-and-gas/prices-tariffs-and-benchmarks/victorian-default-offer p.48

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