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

Victorian Default Offer 2024-25 Comment Paper

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts across eastern Australia. We also own, operate and contract a diversified energy generation portfolio across Australia, including coal, gas, battery storage, demand response, wind and solar assets, with control of over 5,000MW of generation capacity.

EnergyAustralia welcomes the opportunity to provide this submission to the Essential Services Commission's (ESC) request for Comment Paper on the Victorian Default Offer (VDO) 2024-25. We appreciate and generally support the ESC's proposal for regulatory consistency and using the same methodologies as in past reviews. This is generally constructive as retailers rely on a level of predictability in the regulatory landscape to plan for and make efficient decisions which customers benefit from. The ESC's Comment Paper calls out two issues:(1) alternatives to peak swap wholesale electricity futures contracts (2) retail operating margin. Our response is framed around these two issues respectively.

Overall, we have strong concerns with the inconsistent approach taken on the retail operating margin. For the 2023-24 VDO, the ESC revised the retail margin to 5.3% from 5.7%. The reasons provided for this change in the final determination were justified using some of the same reasoning that supported the ESC to consider 5.7% appropriate in its draft determination. In our view, the ESC has not made a justifiable case to depart from the status quo and we consider the retail margin should be reinstated to 5.7%. Decisions that are inconsistent with the regulators own reasoning undermines the regulatory framework and creates a system where outcomes are uncertain and potentially arbitrary. While regulators might be tempted to use discretion to address immediate concerns it runs the risk of creating bigger problems down the line, all the while eroding confidence and trust in the regulator to deliver fair and properly considered outcomes should the practice become the norm.

Our full submission is below. We reserve comments on other aspects of the VDO that we have not discussed in this submission in our response to the draft VDO 2024-25 decision.

If you have any questions in relation to our submission, please contact me (Maria.Ducusin@energyaustralia.com.au or 03 9060 0934).

Yours sincerely,

Maria Ducusin
Regulatory Affairs Lead

1. Wholesale electricity cost methodology

1.1. Removal of peak swaps

We accept the removal of peak swaps from the VDO wholesale benchmark as these products are rarely traded since the widespread adoption of solar power, which has seen peak demand periods less pronounced.

ASX contracting remains an important method for retailers to hedge risk for consumers with base and cap futures contracts being the most common ASX traded instruments. We support the continued use of ASX contracting in modelling the estimate wholesale electricity cost benchmark.

With this in mind, we recognise that relying on ASX contracting in estimating the wholesale cost benchmark can have shortcomings as liquidity becomes more of an issue as the market continues to move away from baseload generation. We support the ESC exploring the use of broker curves which can take into account over-the counter activity and provide valuable insight in parts of the curve that are not trading through the ASX.

2. Retail operating margin

There appears to be no compelling case to justify changing the retail operating margin to 5.3

In our view, the ESC has not made a compelling case to change the retail margin from 5.7% to 5.3%. The draft determination for VDO 2023-24 proposed to keep the retail operating margin at 5.7% noting that:

> Given that there is no clear indication that we should lower or increase our margin, and it is within the range of margins set by other regulators, we have kept the retail operating margin unchanged for the time being.[1]

In contrast, the final determination for VDO 2023-24 reduced the retail margin to 5.3% justified using some of the same reasoning that supported the ESC to consider 5.7% was appropriate in its draft decision. The final determination pointed to the latest retail margins set by other Australian regulators to justify reducing the retail margin to 5.3% stating in its list of reasons that 'retail margins set by other regulators have decreased'.[2] However, this framing is misleading as there was no change to the latest regulatory decisions set by other Australian regulators since the ESC considered these retail margins at the time of the draft determination. The ESC relied on the same logic it previously used to justify maintaining the status quo to help vindicate reducing the margin to 5.3%. We see this reasoning as fundamentally flawed.

The final determination also pointed to other reasoning as grounds to reduce the margin, however we question whether these explanations are made from convenience rather than a genuine basis to reconsider the retail margin. Given the evidence relied on for this reasoning was available at the time of the draft determination and there was no change in circumstances since the ESC considered the draft determination provides credence to the former view. We recognise the temptation for regulators to exercise discretion in their decisions to address immediate concerns, however we emphasise the importance of regulatory transparency in the decision-making process. Regulatory discretion that is exercised on grounds that are inconsistent with the regulators own objective reasoning undermines the regulatory framework.

1 Essential Services Commission, *Victorian Default Offer 2023-24 Draft Determination*, p 42.
2 Essential Services Commission, *Victorian Default Offer 2023-24 Final Determination*, p 48.

A retail operating margin of 5.3% is too low to compensate equity investors

The final determination for VDO 2024-25 expressed that:

> The retail operating profit margin represents the operating profit margin required to compensate investors for the capital they provide retailers. It covers a number of things including:
>
> - systematic risk (non-diversifiable)
> - tax
> - depreciation and amortisation

Taking into account the retail operating margin of 5.3% is intended to cover tax and depreciation, the retail operating margin is actually closer to 2%, which is too low to compensate an equity investor. Expected returns to debt and equity will have increased with rising interest rates. The ESC should consider this in setting the retail operating margin.

Given the ESC's revealed preference we question if there is real scope for reconsidering the margin

The Comment Paper seeks potential alternative approaches in setting the retail operating margin noting that the ESC will only adopt a new approach if it better meets the requirements and objectives of the VDO framework and it is practical to implement.[3] We appreciate that the ESC has been forthcoming about the reality of adopting a new approach.

The ESC has demonstrated a willingness to exercise discretion and depart from the long-established retail margin based on some of the same grounds it previously considered supported the status quo. Therefore, we question whether there is real scope for discussion on the retail margin when the ESC has a revealed preference that 5.3% is now the acceptable retail margin.

We anticipate that re-examining the expected returns approach could see higher figures than when it was previously undertaken by Frontier in 2019 given the change in the economic environment. Should the ESC wish to address the circular problem created by continuing to use benchmarks set by other regulators it could look to rerun the expected returns approach in 2024.

That said, what if the outcomes of examining alternative approaches do not align with the ESC's revealed preference and resulting outcomes are higher than 5.3%? We question whether the ESC would find this acceptable.

Retailers operate in a highly competitive and risky environment reflected by the low average retailer margin the ESC has identified[4] and the unprecedented number of retailer failures last year. The high interest rate environment is also expected to continue beyond the short-term meaning that the cost to finance has increased. With this context in mind, to sufficiently compensate an equity investor for the capital they provide an electricity retailer, we would expect that should the ESC rerun the expected returns approach in 2024 that it considers resulting outcomes in the higher range even if these sit above 5.3% and 5.7%.

Reinstating the retail margin to 5.7% may be the practical way forward

Instead of revisiting the entire approach, reinstating the retail margin to the 5.7% level may be a more practical way forward. We are not persuaded that there has been any change in circumstances since the ESC considered the VDO draft determination for 2023-24 to justify changing the retail margin to 5.3%. Reinstating the margin to 5.7% demonstrates a return to standards upheld in previous reviews, which were long considered by the ESC to be appropriate and effectively met the requirements and objectives of the VDO. A reinstatement would also be simple and practical to implement.

[3] Essential Services Commission, *2024-25 Victorian Default Offer request for Comment paper*, p5

[4] Essential Services Commission, *Victorian Default Offer 2023-24 Final Determination,* p 53.

The ESC should be clearer on when it will assess changes to the retail margin and establish certainty

Following our comments made in this submission, we recommend the ESC:

- Provide clarity and certainty around the circumstances in which it will consider changing the retail operating margin. This will establish clear expectations on when the ESC will revise the retail margin and promote trust and transparency in the regulatory framework.
- Provide certainty on how long it intends to uphold this approach. This will create much-needed regulatory certainty for retailers on what the VDO price will be. We consider this critical as retailers deliver the clean energy transition.