14 December 2023

Ms Kate Symons
Chairperson
Essential Services Commission
Level 8/570 Bourke St
Melbourne VIC 3000

Submitted via website: www.engage.vic.gov.au

Dear Ms. Symons

Victorian Default Offer (VDO) 2024-25 Request for Comment Paper

Thank-you for the opportunity to provide a submission in response to the VDO 2024-25 Request for Comment Paper (the **Paper**).

Momentum Energy Pty Ltd (**Momentum, our** or **we**) is an Australian operated energy retailer, owned by Hydro Tasmania, Australia's largest generator of renewable energy. We pride ourselves on providing competitive pricing, innovation and outstanding customer service to electricity consumers in Victoria, New South Wales, South Australia, Queensland, the ACT and on the Bass Strait Islands. We also retail natural gas to Victorian customers.

1. Introduction

The Paper seeks comments about any issues to be discussed for the 2024-25 VDO and proposes to generally use the same methodologies as in past reviews. It discusses the commitments made at the previous VDO final determination to consider alternatives to determining the retail operating margin and alternatives to using peak swap wholesale electricity future contracts in the estimation of the wholesale electricity cost benchmark.
The Essential Services Commission (**ESC**) chose to remove the impact of peak swap wholesale electricity contracts in the 2023-24 final decision based on the limited use of these risk management instruments by retailers over past years. Momentum generally supports the use of the same methodologies as previous VDO reviews and believes that a consistent, predictable approach to VDO determinations supports retailers with managing risk and their longer-term investment strategies.

1. Retail Operating Margin

Momentum is disappointed to see the retail operating margin reduced in the 2023-24 VDO final decision from 5.7% to 5.3%, as this was not raised in the draft decision. The ESC largely justified this decision based on the progressive reduction in VDO average retail margins (**EBITDA**) which have decreased from 4.8% in 2020-21 FY to 1.5% in the 2021-22 FY[1]. Following the reduction in the retail

[1] FDP - Victorian Default Offer 2023-24 Final Decision - 20230525_0.pdf page 53

operating margin in the 2023-24 VDO final decision from 5.7 – 5.3% the average retail margin (EBITDA) has now been reduced to around **1.1%** (1.5% -0.4% = 1.1%).

The ESC also suggested in the VDO 2023-24 final decision, that the retail operating margin was reduced to align with regulated pricing decisions made by the Office of the Tasmanian Economic Regulator (OTTER) and the Independent Competition and Regulatory Commission (ICRC). Momentum considers that both the Tasmanian and the Australian Capital Territory electricity markets are very different to Victoria, and this is reinforced by statements made in recent reports by both local regulators. In the April 2022 Standing Offer Pricing Investigation[2] prepared by OTTER, they stated that:

- *The Regulator's draft assessment was that Aurora Energy faces lower risks in some areas than other electricity retailers operating in the NEM, especially those that are not part of a vertically integrated business: and*
- *Overall, the Regulator's assessment is that, compared to standalone retailers in other Australian jurisdictions, Aurora Energy may face lower than average risks relating to the wholesale electricity price, setting aside volume-related risks.*

The ICRC stated in their Retail Electricity Price Investigation 2020-24 Draft Report[3] that:

- *The Commission considers that the efficient retail margin in the ACT may be lower than in other NEM jurisdictions, such as Victoria, given the lower level of customer related risks in the ACT.*

Momentum does not believe that it is fair or relevant to continually benchmark retail operating margins between jurisdictions that have differing underlying market structures and consideration needs to be given to the ongoing viability of retailers. As mentioned in our response to the ESC 2023-24 VDO Draft Decision[4]

> *The ESC should undertake a robust and constructive review of the retail margin at distinct timings, for example once every 5 years, to avoid the emotive discussion of the retail margin every VDO decision and to provide certainty to retailers and their investors to ensure an ongoing sustainable market.*

Momentum believes that a retail margin based on a percentage of electricity supply costs is the most appropriate margin mechanism for energy retailing as it supports:

- the recovery of operational costs and a reasonable profit to sustain a retail business essential for the long-term viability of the energy sector;
- flexibility in adjusting retail prices based on changes in the cost of supply. This ensures that consumers pay a fair and proportionate amount relative to the actual cost of providing energy services;

[2] https://www.economicregulator.tas.gov.au/Documents/22%20889%202022%20Standing%20Offer%20Electricity%20Pricing%20Investigation%20-%20Final%20Report%20[FINAL%20VERSION].pdf page 34

[3] https://www.icrc.act.gov.au/__data/assets/pdf_file/0007/1474756/Electricity-Draft-report_pdf.pdf page 43

[4] https://www.esc.vic.gov.au/sites/default/files/documents/Momentum%20Energy.pdf page 2

- energy retailers to be motivated to operate efficiently and seek innovative solutions to reduce the cost of supply. This can lead to advancements in technology, streamlined processes, and ultimately benefit both consumers and the industry;
- an effective competitive environment which can lead to improved services, better customer support, and more competitive pricing as retailers strive to attract and retain customers; and
- a balance between ensuring the economic viability of energy retailers and making energy services affordable for consumers. This approach helps prevent excessively high or low pricing that could negatively impact either party.

2. Wholesale Electricity Cost Benchmark

The wholesale market methodology has been refined over past VDO determinations and we largely support the existing methodology. However, we believe that the substantial rise in interest rates over the past few years has increased the "cost of carry" to fund Australian Stock Exchange (ASX) hedge positions on the ASX. We believe the VDO does not factor in this cost. Due to increased interest rates in the market, higher ASX initial margin requirements, and increased futures prices (against which percentage based ASX initial margin deposits are calculated), the funding cost of holding ASX hedge positions has risen exponentially. As provided on the ASX Energy website, futures traders (retailers) are required to post up to 30% of the futures value in cash with their clearing participant for the life of the hedge. Some clearing participants require their hedge clients to post a significantly higher additional cash margin above this headline margin.

In 2020 and 2021, the "cost of carry" on futures hedges was negligible as interest rates were less and a relatively small initial margin deposit was required on lower priced futures contracts. As the VDO assumes retailers are hedging as soon as the futures trade, this creates a significant additional hedge cost. For example, with a 20% initial margin requirement, a $100/MWh futures contract held for two years at a funding cost of 5% would give rise to a hedge funding cost of: 20% x $100/MWh x [(1.05)^^{2} -1] = $2.05/MWh. Momentum firmly believes that the VDO wholesale methodology should now include this additional "cost of carry" into the 2024-25 VDO and future VDO determinations if the current market arrangements continue.

3. Summary

We are hopeful that our comments above will help shape the VDO for 2024-25 to ensure a fair and reasonable outcome for all market participants. Should you require any further information regarding this submission, please do not hesitate to contact me on 0478 401 097 or email randall.brown@momentum.com.au

Yours sincerely

[Signed]
Randall Brown
Regulatory Manager