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Victorian Default Offer 2021 – Consultation Paper

AGL would like to take this opportunity to respond to the *Victorian Default Offer 2021 – Consultation Paper* (Consultation Paper) released by the Essential Service Commission (ESC) on the 16 June 2020.

The Victorian Default Offer (VDO) was introduced by the Victorian Government to regulate standing offer prices for electricity in Victoria, commencing from 1 July 2019 with the stated objective to provide a simple, trusted and reasonably priced electricity option for customers unwilling to engage in the electricity market[1].

However, many other reforms have been introduced to the Victorian retail energy market since that time including the requirements for Clear Advice Entitlement and Best offer notifications on bills. Because of these changes, the VDO now acts as a price cap for the retail electricity market, rather than as a reasonable alternative to market offers. AGL encourages the ESC to take this into account in making its VDO determination for 2021.

AGL notes that the Consultation Paper is specifically seeking feedback on two concerns:

- the impact of COVID-19 on the retail electricity industry and how to take this into account; and
- how the VDO should accommodate the change in the timing of network price changes from a calendar year basis to a financial year basis.

AGL agrees that these are significant risks in making the VDO determination and believes they can only be effectively mitigated by:

- Setting a VDO to apply for 6 months from 1 January 2021 with a further VDO set for the 2021-22 financial year that is appropriately aligned with the Victorian distribution network tariffs; and
- Including an allowance for the cost of COVID-19 in the shortened VDO to apply from 1 January 2021. AGL has attached confidential estimates of the cost of COVID-19 to this submission but will provide more information to the ESC as the consequences become clearer.

These concerns are discussed below as well as several other cost elements that AGL believes need further consideration to better reflect the efficient costs of running a retail business.

[1] Order-in Council available at http://www.gazette.vic.gov.au/gazette/Gazettes2019/GG2019S208.pdf.

Length of the regulatory period

The VDO determination currently applies for the 12 months calendar year. However, the Victorian Government is amending the timing of Victorian electricity network determinations to run on a financial basis from 1 July 2021. Furthermore, the Victorian Government has requested that the Australian Energy Regulator (AER) set network prices for the six months between 1 January 2021 and 30 June 2021 to reflect changes in the cost of capital.

This means that network charges in Victoria are likely change on both 1 January 2021 as well as on the 1 July 2021. In its Consultation paper, the ESC has proposed several options for adjusting the length of the regulatory period for the next VDO to accommodate these changes:

1. Set the VDO for 6 months only from 1 January 2021 and make a new 12-month determination that will apply from 1 July 2021 to 30 June 2022 (6-month option);
2. Make a VDO determination for an 18-month period from 1 January 2021 (18-month option); and
3. Make no change to the regulatory period and reset the VDO on 1 January each year (12-month option).

Option 1 will take account of the most up to date information and mitigate the risk of the VDO not aligning with cost changes, particularly for network prices, but will require two VDO price changes in a 6-month period for Victorian customers.

Option 2 only requires the one VDO price change over the next 18 months but introduces significant risk of not properly accounting for cost changes, especially the network price change on 1 July 2021. Given the VDO acts as a price cap on the retail market, this is excessive risk.

The third option would reset the VDO on 1 January 2021 but will not reflect the network charges from July 2021 to December 2021 and will sustain this misalignment with network charges in subsequent years. This also introduces significant risk to the competitive retail market and to customers that there pricing will not be suitably aligned to cost.

Network costs constitute the largest component of the VDO cost stack (around 40 per cent for residential customers). Given that the VDO is calculated with no allowance for headroom, it is important that network charges are appropriately accounted for otherwise a small error in forecasting network costs could eliminate any return from the VDO. AGL does not consider Options 2 and 3 to be acceptable.

AGL supports the ESC setting VDO prices for six months from 1 January until 30 June 2021 followed by a new 12-month determination for the period of 1 July 2021 to 30 June 2022. Although this means two price changes for customers, this option has the benefit of allowing the ESC to base its determination on the most up to date information and allow for any significant and unexpected changes in costs that might take place due to COVID-19.

If avoiding two VDO price changes is a priority, AGL proposes that the best alternative would be extending the current VDO for a further 6 months with a re-set from 1 July 2021. However, this does not align with the requirements of the current Pricing Order.

Retail operating costs

The previous ESC decisions allowed for retail operating costs based on benchmarks from the Independent Competition and Regulatory Commission plus an allowance for the introduction of the payment difficulty framework and other regulatory costs. AGL believes this allowance is insufficient to fully account for specific Victorian costs relating to all the recent regulatory changes. Regulatory changes come at a cost to a retail business and have had a significant impact on retailers. While not all costs of operating in Victoria are separately accounted for, the cost of operating in Victoria is higher than that in other jurisdictions.

AGL has also previously highlighted the significant regulatory changes in progress impacting on the energy industry, including 5-minute settlement and the estimated cost to implement the necessary system changes.

The ESC has recognised in its Consultation Paper that COVID-19 has impacted on the financial position of retailers and AGL's comments on this concern follow.

Retail Cost Impacts of COVID-19

First and foremost, COVID-19 has had significant impacts on businesses, consumers and retail costs and these impacts have not been balanced by efficiencies in other retail costs, decreased wholesale prices and the deferral of some network charges.

AGL has assessed the impact of COVID-19 on some cost categories, particularly on bad debts. Bad debts include debt write-offs and provisions for doubtful debt, net of debt recovered.

To assess the impact on net bad debt expense, AGL has modelled a range of scenarios including assumptions on the amount of overdue bills, customers accessing the COVID-19 support program, collection activities, disconnection policies and debt provision rates. These scenarios produce a range of financial outcomes and we have provided information to the ESC in a confidential attachment on an assessment of the impact of COVID-19 on AGL in 2020 and 2021.

Although the Victorian distribution businesses have offered a relief package to defer charges for residential customers in hardship and to rebate network charges for small businesses who have reduced consumption by at least 75 per cent, this is limited to network charges for 3 months up to 30 June 2020. While this is well meant, it has not had a significant positive impact on costs and has required increased operating resources to apply.

AGL is also providing a COVID-19 Customer Support Program for customers who may be under financial stress as a result of the pandemic. Amongst the initiatives, this program allows customers to defer payments or enter payment plans, with no disconnections. It is in addition to AGL's well established hardship program. While these initiatives are necessary due to the difficulties some customers face in these circumstances, they add to the cost of operating as a retail business.

Recently, the ESC has proposed a package of reforms, "*Supporting energy customers through the coronavirus pandemic*", to be implemented through amendments to the Energy Retail Code. While AGL supports the intent of this package, compliance with this proposal and the additional requests for data will increase the costs of operating in this environment.

There are also 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. These costs are currently difficult to track and estimate currently.

However, the impact of COVID-19 on retail operating costs is directly evident in the increase in net bad debt expense. While it is uncertain how long this elevated level of bad debt will remain, these are costs incurred by retailers and at a minimum, AGL believes the ECS should provide an additional allowance for this unexpected cost in the retail operating cost benchmark for the 2021 VDO.

Network costs

AGL supports the ESC proposal to pass through network costs in line with its previous VDO determinations. However, AGL does have some concerns regarding the process and timing of the determination, submission and approval of Victorian network costs for 1 January 2021.

AGL understands that the AER has been requested to set network prices for the six months after 1 January 2021 to reflect changes in the cost of capital. Any delays in the timing of this process will impact on the ability of the ESC to use approved network prices in its determination on the 25 November 2020.

Furthermore, because this is an ad hoc network pricing process, there are no adequate network determination forecasts or public estimates for the ESC to rely on. AGL encourages the ESC to coordinate with the AER to ensure actual network tariff changes can be utilised in the VDO determination.

Retail operating margin

For the 2020 VDO, the ESC applied a retail operating margin of 5.7 per cent based on previous regulatory decisions by Australian regulators. In a normal year and to maintain a level of predictability, AGL would support the ESC proposal to keep the same benchmarking approach for setting an allowance for retail operating margin.

However, this allowance for retail operating margin is only valid if all the components of the cost stack are appropriately accounted for which includes the cost of COVID-19, a risk that has not been considered in any previous derivations of retail margin.

AGL believes that the ESC should directly provide an allowance for the additional costs of COVID-19 but if this is not accepted, the ESC will need to revisit its retail margin benchmark in order to allow for the increased risk profile faced by electricity retailers. Similarly, if the ESC is required to forecast network tariffs then this would also require this additional risk to accounted for in the retail margin.

Wholesale electricity costs

AGL generally supports the market approach used by Frontier for estimating wholesale electricity costs for the VDO and is therefore supportive of the ESC maintaining a consistent approach for the 2021 VDO.

However, the ESC and its consultants, Frontier, will need to carefully consider the underlying data used to calculate wholesale electricity costs for 2021.

AGL's data on Victorian demand and consumption over the period affected by COVID-19 and subsequent Government restrictions has shown no significant change in Victorian System average demand and it has stayed in the range of previous years.

However:

- demand and consumption for small business and commercial and industrial (C&I) customers is significant reduced compared to prior years; and
- average and peak demand for residential load has increased along with average consumption which on a system wide basis, has counteracted the fall in small business and C&I load.

Consequently, the question will be for the ESC whether the changes to patterns of consumption due to COVID-19 will extend into the 2021 calendar year and therefore whether Frontier should look at incorporating this recent data into its modelling. Using only the underlying data from 2016 to 2019 will not adequately reflect these marked changes.

Again, AGL believes determining the VDO for only 6 months from 1 January 2021 would provide the ESC with the opportunity to incorporate recent data as the second VDO applied from 1 July 2021 can utilise data that is commensurate with the situation at that time.

Environmental schemes and other regulatory costs

AGL largely supports the approaches previously used by the ESC but considers the following elements of the cost stack require further consideration in this determination:

- Large-scale Renewable Energy Target (LRET): AGL has accepted the ESC using the market price for LGCs to determine the cost of complying with the LRET but in the last VDO price determination suggested that the ESC would need to consider an alternative approach because the LGC market prices are no longer relevant to the cost of the scheme. AGL maintains this view as the movements in LGC market prices are not reflective of retailers' underlying cost of procuring LGC certificates. AGL believes the ESC will need adopt an alternative method such as estimating a long-term resource cost for industry based on historical PPA prices and LGC formation;
- Small-scale Renewable Energy Target (SRET): As recognised by the ESC in its Consultation Paper, there has been a substantial difference in the forecast of the small-scale technology percentage (STP) by the Clean Energy Regulator (CER) and the actual binding small-scale technology percentage that is finally published. AGL appreciates the ESC made an adjustment for this in its 2020 VDO price determination and it is expected that this will again be required. AGL believes that a better estimate than the 2-year average is required and can be readily forecast as data becomes available on STC creation and exemptions.
- Reliability and Emergency Reserve Trader (RERT): The ESC has previously included the costs of the RERT based on AEMO' s reporting but AGL maintains that this is not cost-reflective of the costs of the scheme for mass-market customers. AEMO uses the RERT to maintain power system reliability and system security by paying for additional capacity to be on stand-by. It appears that AEMO in its RERT report[2] allocates the cost of this on an average consumption basis instead of allocating it on customers' actual share of total demand during these RERT periods. As the RERT is being used more often and as costs increase, AGL believe it is more important that these costs are allocated appropriately to the major drivers of demand during these peak demand periods, namely mass-market customers.
- AEMO Directions: There have been several AEMO directions in Victoria in the last financial year, with considerable costs to consumers.[3] During the quarter, AEMO issued directions in Victoria to maintain system security, including during the 31 January power system separation event. Total NEM directions costs reached $33 million and Victoria accounted for 53% of these total direction

[2] https://aemo.com.au/-/media/files/electricity/nem/emergency_management/rert/2020/rert-quarterly-report-q1-2020.pdf

[3] AEMO, *Quarterly Energy Dynamics Q1 2020 Market Insights and WA Market Operations*

costs. AGL requires the ESC to include the cost of AEMO directions into its VDO price determination.

Maximum bill

The 2020 VDO regulates the non-flat tariffs, such as time of use and demand tariffs, by setting the maximum bill amount based on the flat VDO tariffs at the representative customer usage level (4 MWh a year for a residential customers and 20 MWh a year for a small business customer).

AGL currently support the ESC's proposal to maintain this approach although calculations of network charges using the representative profiles show that there are some differences between the flat tariffs and non-flat tariffs. The potential negative impacts of this approach will be limited by if the ESC is only setting the VDO for the 6-month period as proposed with little structural variation in network tariffs expected on 1 January 2021.

However, we note that the five Victorian distribution businesses are proposing to introduce new default two-rate time of use tariffs for residential and small business customers from 1 July 2021 when the new five-year regulatory period commences.

The introduction of time of use tariffs is considered important to gain the full benefit of the rollout of smart metering in Victoria but residential customers can currently opt-out of the time of use tariffs. It will be useful to monitor the take-up of these time of use tariffs, the level of costs compared with the flat tariffs and the level of mandatory take-up required as a result of the new Victorian network determinations and Tariff Strategy Statements for 1 July 2021.

If there is significant take up and the material differences in pricing, it may be necessary for the ESC to establish standing offers for time of use tariffs from 1 July 2021.

Variation mechanism for our 2021 VDO determination

Although AGL supports a variation mechanism in an annual VDO determination, it is unlikely to be utilised apart from in exceptional circumstances. AGL agrees with the ESC that implementing a 6-month regulatory period for the next VDO, as discussed in the section above on the length of regulatory period, would preclude the need for a variation mechanism in this VDO determination.

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

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