



AGL Energy Limited
ABN: 74 115 061 375
Level 24, 200 George St
Sydney NSW 2000
Locked Bag 1837
St Leonards NSW 2065
t: 02 9921 2999
f: 02 9921 2552
agl.com.au

Victorian Default Offer 2021
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, Victoria 3000

Online via: <https://engage.vic.gov.au>

8 October 2021

Victorian Default Offer 2022 – Draft Decision

AGL would like to take this opportunity to respond to the *Victorian Default Offer from 1 January 2022 – Draft Decision* (Draft Decision) released by the Essential Service Commission (ESC) on the 7 September 2021.

AGL support the ESC's decision to continue to largely use the same approach as the 2021 VDO price. This provides some certainty for industry participants.

AGL agree that a regulatory period of six months is appropriate so that the next annual regulatory period can commence on a financial year basis in line with network price changes. The recovery of the network tariff changes for July and August 2021 is also supported.

However, as noted in discussions with the ESC, there are several areas which warrant further consideration. Most significantly, AGL disagree with the use of an annual wholesale energy cost for this 6-month regulatory period. The impact of seasonality on contract prices, in particular caps, means that this decision significantly underestimates the wholesale energy cost for the 6-month period and is not based on the efficient costs of a retailer, as required under clause 12(3) of the pricing order¹. Unless the ESC was planning a true-up in financial year 2022-23, AGL believes this approach cannot be justified and note that Frontier Economics (Frontier) makes no comment on this issue in its draft report². AGL strongly encourages the ESC to reconsider its draft methodology and, in conjunction with Frontier, consider alternatives that will satisfy its regulatory requirements.

Other matters AGL would like the ESC to consider are:

- the assessment of VEU program costs;
- the removal of the allowance for additional bad debts due to COVID-19; and
- whether benchmarks continue to reflect retailers' costs.

¹ Order in Council made under section 13 of the Electricity Industry Act 2000 and published in the Victorian Government Gazette No. S 208 on Thursday 30 May 2019.

² Frontier Economics, Wholesale electricity costs for 2022 – a draft report for the Essential Services Commission, August 2021.



More detailed comments in response to aspects of the Draft Decision are detailed in an Attachment A.

If you have any questions in relation to this submission, please contact Patrick Whish-Wilson, Senior Manager Regulatory Strategy, at pwhish-wilson@agl.com.au.

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Elizabeth Molyneux'.

Elizabeth Molyneux
GM of Policy and Market Regulation



Attachment A: AGL Responses to the ESC Draft Decision

Wholesale electricity costs

AGL continues to generally support the market approach used by Frontier to estimate wholesale electricity costs for the purpose of determining VDO prices.

However, we disagree with the ESC's draft methodology to maintain consistency with previous reviews and simply use an annual wholesale electricity cost modelled by Frontier for this 6-month period.

This approach does not consider the impact of seasonality, that the actual cost of hedging will vary considerably on a quarterly basis and therefore that the use of an annual wholesale energy cost for this 6-month regulatory period without a true-up will:

- materially underestimate the wholesale electricity cost for the 6-month period; and
- not be based on the efficient costs of a retailer, as required under clause 12(3) of the pricing order³.

This is regardless of retailers' different hedging strategies and preference to reset retail prices only once a year.

In Table 1 below, AGL has provided a basic but indicative example showing that retailer costs are not flat across the year but instead vary from one quarter to another. It shows that a decision that does not take account of that seasonality would result in retailers materially under-recovering costs. It determines the hedging cost for a retailer by simply using the 12-month trade weighted base swap prices estimated by Frontier in Table 1 of their report⁴. This significantly underestimates the actual hedging cost as it ignores both peak swap and cap contract prices, which are particularly important in hedging Q1 load and have more pronounced seasonal price variation than base swaps, but is sufficient to illustrate the issue.

The analysis assumes retailer has a mass-market load of 1000 GWh per quarter to derive the quarterly costs and indicates an underlying hedging cost of \$99 million for the first 6 months of 2022. The draft VDO allowance for recovery is the annual average of the quarterly base swap prices for 2022, in line with the ESC's proposed method, i.e. \$43.80 per MWh. This provides revenue recovery of around \$88 million over the first 6 months of 2022 which is almost **\$12 million or 12% below** the underlying cost over the period.

The under-recovery is material. Furthermore, the analysis is highly conservative, as it does not include:

- the variance of the peak swap and \$300 cap contracts (which have significantly more pronounced seasonality);
- the impact of differences in the variability of seasonal load shapes; nor
- the differences in hedging positions appropriate for each quarter.

This basic analysis nevertheless shows that the ESC's draft methodology for estimating a WEC allowance to apply for this 6-month period will not reflect the efficient cost of a retailer and therefore does not comply with the pricing order and the ESC Act⁵, which requires the ESC to consider the financial viability of the industry.

³ Order in Council made under section 13 of the Electricity Industry Act 2000 and published in the Victorian Government Gazette No. S 208 on Thursday 30 May 2019.

⁴ Frontier Economics, Wholesale electricity costs for 2022 – a draft report for the Essential Services Commission, August 2021, p27.

⁵ Section 8A(1)(b) of the ESC Act.



Table 1: Indicative impact of Draft VDO methodology

Quarter	Underlying Cost		Draft VDO Method		Difference
	(\$/MWh)	(\$m)	(\$/MWh)	(\$m)	
Q1 2022	\$59.53	\$59.5	\$43.80	\$43.8	
Q2 2022	\$39.82	\$39.8	\$43.80	\$43.8	
Total Cost H1 2022		\$99.4		\$87.6	- \$11.8
Q3 2022	\$40.40	\$40.4	\$43.80	\$43.8	
Q4 2022	\$35.46	\$35.5	\$43.80	\$43.8	
Q1 2023	\$59.53	\$59.5	\$43.80	\$43.8	
Q2 2023	\$39.82	\$39.8	\$43.80	\$43.8	
Total Cost FY23		\$175.2		\$175.2	-
Cost 18-months		\$274.6		\$262.8	- \$11.8

Note: Base swap prices from Frontier report are used for the quarterly \$/MWh cost in 2022 and we assume the 2023 Q1 and Q2 \$/MWh costs are the same as for 2022. Actual cost and VDO recovery based on 1000 GWh of mass market load per quarter.

In its Draft Decision, the ESC justifies its approach of using the annual wholesale cost based on:

- providing a better outcome for VDO customers and balancing customer and retailers' interests;
- ensuring retailers do not recover more than efficient cost;
- that standing offers only cover a very small share of total customers for most retailers; and
- retaining a consistent approach with previous reviews, including its 2019 review, which also applied for a 6-month period.

We disagree with these justifications.

The analysis instead highlights that the proposed approach will result in prices that ignore retailers' interests, are below efficient cost, and will likely have material financial impact on retailers due to a VDO that is not cost reflective being used as a reference price and in "Better Offer" calculations.

We also note the VDO of 2019 was a completely different situation. It was the first setting of a VDO and the legislation to implement the VDO was only introduced into Parliament in February 2019. Retailers had already made their annual price changes in January 2019 and these price changes would have assumed an annual wholesale cost estimate for 2019. The ESC using an annual wholesale cost estimate for 2019 in this instance was therefore appropriate as it estimated what retailers needed to recover for their average wholesale electricity cost, including the higher costs incurred over quarters 1 and 2 of that calendar year.

AGL has identified two potential alternatives to resolve this issue:

- a) Estimating a wholesale energy cost that only reflects the cost of the first half of 2022, using the relevant contract prices and load shape. The \$/MWh allowance increases when using a 6-month WEC because it is only averaging the higher cost of quarter 1 over two quarters rather than four. This approach is far from perfect, and AGL does not consider that costs should be estimated for a 6-month period in normal circumstances, however, this is an unusual situation arising from the transition from calendar to financial year; or



- b) The ESC maintains its current methodology of estimating a single annual wholesale electricity cost for the 2022 VDO but noting that the under-recovery in retailers' cost for the first 6 months of 2022 will be recovered as part of the 2022-23 VDO, similar to the recovery of network charges in this VDO determination. The extent of the under-recovery could be assessed as part of the process to determine the 2022-23 VDO and smeared across the 2022-23 financial year.

These options are also shown in Table 2 replicating the basic analysis from above. With option a, there is no under-recovery in the first 6-months of 2022 while under option b, a \$/MWh adjustment is needed in the 2022-23 VDO (in this example being \$2.94 /MWh) for the retailer to recover the underlying wholesale costs that weren't recovered in the first half of 2022.

Table 2: Indicative impact of using alternative methodologies

Quarter	Underlying Cost		a) Using the 6-month WEC		b) Adjusting the FY23 WEC	
	(\$/MWh)	(\$m)	(\$/MWh)	(\$m)	(\$/MWh)	(\$m)
Q1 2022	\$59.53	\$59.5	\$49.68	\$49.7	\$43.80	\$43.8
Q2 2022	\$39.82	\$39.8	\$49.68	\$49.7	\$43.80	\$43.8
Total Cost H1 2022		\$99.4		\$99.4		\$87.6
Q3 2022	\$40.40	\$40.4	\$43.80	\$43.8	\$46.74	\$46.7
Q4 2022	\$35.46	\$35.5	\$43.80	\$43.8	\$46.74	\$46.7
Q1 2023	\$59.53	\$59.5	\$43.80	\$43.8	\$46.74	\$46.7
Q2 2023	\$39.82	\$39.8	\$43.80	\$43.8	\$46.74	\$46.7
Total Cost FY23		\$175.2		\$175.2		\$187.0
Cost 18-months		\$274.6		\$274.6		\$274.6

Note: Base swap prices from Frontier report are used for the quarterly \$/MWh cost in 2022 and we assume 2023 Q1 and Q2 \$/MWh are the same as for 2022. Actual cost and recovery are based on 1300 GWh of mass market load per quarter.

AGL believes Frontier have the capability to adjust their market modelling for estimating wholesale electricity costs to support either of these alternatives and ensure that retailers do not under-recover their wholesale electricity costs as a result of this one-off transition from a calendar to financial year basis.

Environmental schemes

Small-scale Renewable Energy Scheme (SRES)

To set an allowance for the Small-scale Renewable Energy scheme costs, the ESC has used the average of the non-binding small-scale technology percentage for 2022 and the binding small-scale technology percentage for 2021, multiplied by the clearing house price. In addition, the ESC has included an allowance for the level of the difference between the forecast small-scale technology percentage used in the 2021 VDO and the actual binding small-scale technology percentage for 2021.

AGL support the true-up mechanism as the non-binding STP has consistently understated the binding STP by a significant amount in recent years. For example, in 2021, the non-binding STP was 19.4% compared with the binding STP of 28.8%.



Victorian Energy Upgrades (VEU)

The market price of Victorian energy efficiency certificates (VEECs) has increased significantly as COVID-19 restrictions continue to limit eligible activities. The Victorian Energy Upgrades program has also phased out certain activities. Current market prices are around \$80 per certificate.

In addition, the penalty price has increased from \$50.83 per certificate in calendar 2020 to \$70 per certificate in 2021 and \$80 in 2022. The increase in the penalty price, and changes in the scheme which decreased eligible activities, has increased, and will continue to support higher certificate prices.

Therefore, in AGL's view, the ESC estimate of the average price per certificate of \$49.64 in the Draft Decision is significantly below current market prices and is unlikely to reflect future certificate prices. We suggest that ESC consider:

- excluding pre-2021 certificate prices to ensure more current values are used; or
- using a 12-month trade weighted average of certificate prices as this may provide a better reflection of actual costs.

Retail operating costs

The underlying benchmark for retail operating costs can be attributed to the Independent Competition and Regulatory Commission's 2017 decision for retail electricity prices in the Australian Capital Territory. This benchmark can be traced back to the determination by the Independent Pricing and Regulatory Tribunal in 2013 for retail electricity prices in New South Wales. While there is an allowance principally for the payment difficulty framework in Victoria, the underlying benchmark has not been adjusted in real terms for many years.

The ESC has noted that:

"Retail operating costs reflect a range of costs incurred by an electricity retailer in conducting its business, this includes billing and revenue collection systems, information technology systems, call centre costs, corporate overheads, energy trading costs, provision for bad and doubtful debts and regulatory compliance costs."

While there has been some focus on adjustments to this cost benchmark, there has been little consideration on the appropriate level of this cost benchmark. AGL has provided the ESC with detailed cost information for three years up to FY2020. The data shows that the current benchmark understates the fully allocated cost of operating a retail business which must incorporate depreciation and amortisation costs, as well as corporate or centrally managed expenses. Depreciation and amortisation costs are significant, representing the costs of IT systems which are integral in retail operations and for business transformation and digitalisation.

AGL recognise that this determination of the VDO is for a 6-month period and the limited time may not allow for a fulsome review of the benchmark. In its absence, AGL support the continued application of CPI.

However, as the benchmark understates retailers' costs, it is not appropriate to consider cost savings and productivity factors. In addition, while there have been references to publicly listed company reports, it is unclear if they represent the benchmark retailer as there are over 20 retailers operating in Victoria. These public companies are also complex and have significant businesses other than energy retailing.

As the current benchmark is below retailers' costs, it is appropriate to allow for additional costs due to regulatory changes and unforeseen events which the IPART/ ICRC benchmark would not have considered.



Impact of COVID-19 on bad debts

The ESC has proposed the removal of the \$6 per customer allowance for COVID-19 related bad debts from 1 January 2022. A stated reason for this is that in a recent investor presentation AGL reported COVID-19 related net bad debt expenses of \$29 million for FY2021 but stated that the outlook for FY2022 featured cost reductions including a lower net bad debt expense.

AGL's view is that it is premature to remove this allowance. There is still uncertainty around the extent of the impact of COVID-19 and the extent of the current lockdowns in NSW and Victoria was not anticipated.

Disconnections have been suspended in Victoria and the number of customers eligible for disconnections have increased. [REDACTED]



Attachment B: Debt 2019-21 - Confidential

[Redacted text block]

[Redacted text block]

[Redacted text block]

[Redacted text block]

[Redacted text block]