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**Submitted via Engage Victoria**

Commissioners
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne, VIC 3000

Dear Commissioners

# 2022 Victorian Default Offer

Consumer Action Law Centre (**Consumer Action**) welcomes the opportunity to comment on the Essential Services Commission's (the **Commission**) consultation paper, *Next steps for the Victorian Default Offer* (the **Consultation Paper**). These comments relate to the approach to the 2022 Victorian Default Offer (**VDO**).

The Consultation Paper notes the objective of the VDO is to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity market.[1] This has also been described by the Commission as 'universal access to a fair priced electricity offer'.[2]

Consumer Action strongly supports the VDO. As we have said previously, we consider that fairness and community expectations demand that the VDO be set at no more than absolutely necessary to ensure bills remain affordable, particularly for those who are unable to effectively engage in the energy market. We believe these expectations should be at the forefront given the impacts that the COVID-19 pandemic has had on the Victorian community and the ongoing financial disruption that it has on households.

We urge the Commission to pursue measures that will put downward pressure on the VDO price. Efficiency and productivity gains by energy retailers—as well as the fact median market offers are below the VDO—suggest elements of the cost stack including the retail margin and methods used to calculate wholesale costs are overly generous.

The bad debt pass through due the COVID-19 pandemic set a poor precedent for what costs are rolled in to the VDO and we urge the Commission to both remove it and undertake a review. If allowances for bad debt in the 2021 VDO were above retailer forecasts then customers should be refunded. We also comment on the power imbalance between retailers, customers and the Commission and the risk that voluntary data that drives up costs may continue to be added to the VDO cost stack.

We have recommended the Commission revisit its previous comments regarding a 'productivity factor' and introduce this in the 2022 VDO.

We also reiterate comments made in the last VDO reset regarding wholesale costs and suggest greater scrutiny should be applied to setting and cross checking these costs. Continuing to rely on methodology that overestimates wholesale costs and ignore other approaches used by retailers is inefficient.

[1] Clause 3 of VDO Pricing Oder
[2] Commission, Advice on VDO to apply from 1 July 2019, page 14.

Our comments are detailed below. A summary of recommendations is available at **Appendix A**.

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## About Consumer Action

Consumer Action is an independent, not-for profit consumer organisation with deep expertise in consumer and consumer credit laws, policy and direct knowledge of people's experience of modern markets. We work for a just marketplace, where people have power and business plays fair. We make life easier for people experiencing vulnerability and disadvantage in Australia, through financial counselling, legal advice, legal representation, policy work and campaigns. Based in Melbourne, our direct services assist Victorians and our advocacy supports a just marketplace for all Australians.

## Temporary bad debt pass through

In our submission to this Consultation Paper regarding the variation proposal, we called for the temporary bad debt allowance to be removed as part of the variation. We have noted in previous VDO submissions that the primary service energy retailers provide is financial risk-management, since electricity at the point of end use is a physically undifferentiated product. On principle, customers should not bear the costs of wholesale market risk including cost impacts of the pandemic and the bad debt allowance should be removed.

We find it problematic that forecast – that is, unknown – bad debt provisions were allowed to be included in the 2021 VDO. It stands in contrast to other elements of the cost stack that are carefully scrutinised by the Commission and sets a bad precedent for other 'temporary' costs to be added onto the VDO in future.

Retailers must have an incentive to engage appropriately and assist clients with debt. Ensuring retailers are exposed to the cost of 'mistakes' or sub-optimal risk management strategies also provides an incentive for energy businesses to manage their retail operations in a prudent way rather than pass losses through to customers. Figures from the Commission show that there are over a quarter of a million Victorian residential customers in arrears that are not receiving any payment assistance from their retailer.[3] The average arrears of these customers is $495 which would indicate the majority are entitled to assistance under the Payment Difficulty Framework. Allowing energy retailers to simply pass on costs associated with 'bad debt' through the VDO sets up a perverse incentive to let those debts accumulate on the retailers' books knowing that then may be recovered through the VDO.

We note that the Commission has reviewed bad debt provisions and found they were "about the same as or better than anticipated" when the 2021 VDO was finalised.[4] The Consultation Paper also notes that Origin has carried over its bad debt provisions and AGL has revised their bad debt provisions down by $5 million.[5] This is problematic – it means that customers are potentially paying higher prices than are necessary based on guesses by retailers about COVID-19 related debt and discretion by the Commission that these costs be *added* to the VDO cost stack. Our position remains that bad debt costs should come out of retailers' general revenues and not be specifically borne by users of an essential service though additions to the VDO.

In addition to removing the bad debt provision, we would like to see the Commission undertake a more thorough review of the bad debt expenses to ensure that any overpayment by customers during the current regulatory period is accounted for when setting the 2022 VDO. This review could look at estimations provided by retailers related to bad debt forecasts and cross-checking between actual bad debt levels and publicly available information such as annual reports, board presentations, and other financial reporting aimed at investors. If allowances for bad debt in the 2021 VDO were above retailer forecasts then customers should be refunded.

**RECOMMENDATION 1.** Remove the allowance for bad debt expenses due to the COVID-19 pandemic from the VDO.

**RECOMMENDATION 2.** Undertake a thorough review of the bad debt costs that were added onto the 2021 VDO and refund customers if necessary.

## Cost-stack creep

The Commission should also consider developing guidance around what items may be included in the VDO cost-stack should future economic disruptions arise and how this corresponds to the policy intent of the VDO, relevant Acts and the pricing order. Allowing retailers free reign to provide additional information to the ESC on a voluntary basis as an input to the VDO regulatory process will likely see VDO costs creep up over time and risks undermining

[3] https://www.esc.vic.gov.au/electricity-and-gas/market-performance-and-reporting/energy-customer-support-during-coronavirus-pandemic
[4] Consultation Paper page 15
[5] Consultation Paper page 15-16

consumer trust in the VDO. We note that the industry appear to be gearing up for greater advocacy to increase cost allowances recognised by regulators in retail price decisions.[6]

There has been a trend of additional items being considered as part of the cost stack in VDO reviews. These include measures such as the bad debt pass through discussed above and the five-minute settlement changes. We note that items such as these, if accepted by the Commission, lead to an increase in cost estimates and a higher VDO.

Given the inherent information asymmetry between the ESC and retailers, there is an incentive for companies to provide information which is likely to increase cost estimates, and not to provide information which would tend to decrease cost estimates. Relying on voluntary data provision by retailers without cross checking this information will lead to systematic overestimation of costs resulting in certain components of the VDO being set inefficiently high. Additionally, we are concerned about setting a precedent whereby retailers can simply nominate items that should be added on to the cost stack.

The policy intent of the VDO was to put downward pressure on the prices customers were paying for electricity. Allowing items to creep into the cost-stack risks undermining the original intent of the VDO which is to provide a simple, trusted and reasonable price for energy.

**RECOMMENDATION 3.** The Commission should consider developing guidance to provide clarity around when discretion will be used to allow additional items to the VDO cost stack.

## Productivity factor

The Commission suggested in 2019 that there may be merit in applying an annual 'productivity factor'. We are disappointed that the initial view of the Commission in this Consultation Paper is not to include this in 2022 despite acknowledging falling retail costs and productivity improvements in the energy sector. We urge the Commission to revisit its initial statements regarding the productivity factor and incorporate it into the 2022 VDO.

Given the factors being considered that would lead to increases in costs, we would like to see the Commission pursue measures that would lead to decreasing costs. Introducing a productivity factor would make clear the Commission's intention that retail costs should decrease over time. It would be a perverse policy outcome if retail costs were to increase steadily over time because of inefficiencies on the part of retailers and that these costs were then passed through to end users. It would also go some way in offsetting the information asymmetry between retailers and the Commission that can be gamed by retailers by way of providing additional information to the ESC on a voluntary basis as an input to the regulatory process with the result of driving up cost estimates.

Any for-profit business generally aims to become more efficient over time and it is natural that in a well-functioning marketplace that customers would benefit from such efficiencies. We have noted in past VDO submissions that some retailers have made, and continue to pursue, large cost savings in their retailer businesses. For example, Origin noted in its March 2021 Quarterly Report that they "continue to target significant retail cost savings and are on track to achieve $100 million in savings by the end of FY2021."[7] If voluntary information provided by retailers as part of setting the VDO leads to increases in cost estimates it seems fair that other information should be sought by the Commission that may offset those increases or decrease cost estimates.

The Consultation Paper suggests that other inquiries that could lead to decreasing costs, such as examining the operating cost benchmark, may be explored. We suggest the Commission explore multiple avenues in order to drive down the VDO – e.g. cost benchmarks and productivity factor. We reiterate however that introducing some mechanism to provide efficiency incentives to retailers must be prioritised. Citing market volatility as a reason to delay, in our view, is unjustified given that measures closely linked to this same market volatility (the bad debt pass

[6] https://www.energycouncil.com.au/analysis/the-retail-regulatory-framework-still-fit-for-purpose/

[7] Origin, ASX/Media Release, Quarterly Report March 2021, 30 April 2021

through) were added to the 2021 VDO based on forecasts and not settled data or long-term stable market conditions.

**RECOMMENDATION 4.** The Commission pursue measures that would lead to decreasing costs including introduction of a productivity factor in the 2022 VDO.

## Wholesale costs

The Commission should incorporate approaches that ensure wholesale price benchmarks align with actual costs faced by retailers.

We noted in our comments on the variation proposal that the Australian Competition & Consumer Commission's (**ACCC**) monitoring of spot prices has shown significantly lower prices over the past year. At least partly based on "much lower wholesale electricity costs", ACCC analysis of price changes is that flat rate offers have fallen in Victoria by 11.1 to 14.2 per cent compared to June 2020 "and a typical household on a flat rate offer should save between $171 and $198 a year."[8] Arguably, these savings should flow through to the VDO.

We would like to see other approaches explored by the Commission to calculate wholesale costs including strategies of vertical integration and power purchase agreements used by retailers. The current approach risks over-estimating the cost of wholesale energy. Frontier Economics' own analysis of wholesale costs in the 2021 VDO reset even acknowledged that by focusing on ASX-traded energy derivatives, while excluding other risk-management strategies that retailers are able to use, regulators will systematically overestimate the hedging component of wholesale costs. These inflated costs are then passed on to households via the VDO.

The Commission should seek methods to incorporate the full range of risk-management strategies available to retailers into their wholesale cost estimates. In the absence of these methods, cost estimates based on derivatives-only hedging should be treated as an upper bound for hedging costs, not an 'efficient' estimate.

It is positive to see the Commission investigate other data related to wholesale costs, such as newly listed cap contracts. The Commission should also collect data to cross check wholesale benchmarks against the actual range of wholesale and hedging costs paid by all retailers. Since efficiency, by definition, is about providing a service at lowest cost, 'efficient' benchmarks should in the first instance be located at the bottom of this range.

**RECOMMENDATION 5.** The Commission should incorporate approaches that ensure wholesale price benchmarks align with actual costs faced by retailers.

**RECOMMENDATION 6.** The Commission should cross check modelled wholesale costs including hedging against observed data on retailer costs. Where a range exists, efficient costs should be presumed in the first instance to sit at the low end of the range.

## Retail operating margin

We are pleased to see the Commission undertake an initial review of margins and compare it to other jurisdictions in Australia. The Consultation Paper reveals that the margin set by the Commission – 5.7 per cent – is at the top of the of the range when compared to other Australian jurisdictions. This suggests that the margin in the VDO is generous and that there may be room for it to be reduced, particularly recognising the bill affordability challenges associated with the economic effects of COVID-19.

The Commission has said in the past that since the VDO was first applied, new retailers continue to emerge and retailers are still providing market offers at prices below the VDO.[9] This suggests that allowances in the VDO may

[8] https://www.accc.gov.au/media-release/900-million-in-electricity-bill-savings-available-to-households
[9] Essential Services Commission, Consultation Paper, Victorian Default Offer 2021, p 13.

be unreasonable. Given the falling retail operating costs and productivity improvements in the sector we suggest there is ample scope to reduce this margin.

We also reiterate the point we made in our 2021 VDO submission: the use of benchmarking risks becoming circular as it relies on other regulators' historic decision-making, which often relies on prior decisions. That is, if the Commission has looked margins used by other regulators, then there should be scrutiny of how those margins were determined. If regulators only look to other regulators to set or compare operating margins, it will only reinforce the numbers potentially without any independent evidence to underpin them.

The Commission should consider obtaining updated independent advice regarding efficient retailer operating margins. Recognising the information asymmetry between industry, regulators and consumers, margins should be set at the lower end of any recommended range. The Commission could also consider different ways of introducing retailer incentives through the setting of retail margins and perhaps frameworks like the Commission's PREMO model in the water sector could be useful in this regard.

**RECOMMENDATION 7.** The Commission should conduct independent modelling as to an appropriate benchmark for efficient retail operating margin and set the allowance at the lowest point of any range given.

## Five-minute settlement

We agree with the Commission that there should be no additional allowance relating to the five-minute settlement change. We believe costs such as these are already captured in the retail operating margin. Again, we reiterate points about cost stack creep made earlier in that allowing retailers to volunteer new information that could be included in the VDO cost is a slippery slope.

Estimating costs for systems changes inherently involves some uncertainty since each change is different and there is no directly analogous historical data to base estimates on. We believe that costs of updates to retailers' IT and other systems should not be rolled into the VDO, since retailers need to undertake periodic systems updates even without regulatory change.

There may even be scope to pursue lower costs on grounds that retailers may even gain some efficiencies by installing new systems as many IT systems need to be updated periodically to remain fit for purpose.

**RECOMMENDATION 8.** There should be no additional allowance for five-minute settlement.

## Distribution and marginal loss factors

We encourage the Commission to seek data that may offset losses. For example, the grid is no longer a one-way energy flow and Victoria's distributed energy generation should in theory mean less electricity is lost in transmission networks. Increasingly, energy is generated and consumed close to the source compared to previous decades where electricity could travel long distances before being used. The Commission's approach to calculate loss factors should factor this in.

**RECOMMENDATION 9.** Calculation of distribution and marginal loss factors should factor in increasing distributed energy generation which should offset losses.

## Network tariffs

As stated in our submission on the variation proposals, we support the Commission's decision to cap non-flat tariffs through specifying a compliant maximum annual bill as this is a simpler way to ensure compliance and should allow customers to understand how the VDO impacts them rather than using a more complicated methodology.

We encourage the Commission to monitor the changes to tariff structures and how this impacts customers, particularly customers on low or fixed incomes and who may struggle to pay for energy. Electricity contracts are already confusing for consumers and can exacerbate existing consumer vulnerability.[10] Complex pricing arrangements can also make comparisons difficult and we are wary that time of use contracts will make this worse. On the face of it, a compliant maximum bill should make things simpler and comparison between offers easier.

We note the Commission will not calculate separate wholesale costs for peak and off-peak periods for the time of use VDO. We encourage the Commission to monitor this as the continued introduction of solar and battery storage into the grid has the potential to drive wholesale prices lower and these benefits should be passed on to consumers.

## Length of regulatory period

We support a 6 month regulatory period for the 2022 VDO to align future reviews with Victorian network businesses' regulatory periods.

Please contact **Patrick Sloyan** at **Consumer Action Law Centre** on 03 9670 5088 or at patrick@consumeraction.org.au if you have any questions about this submission.

Yours Sincerely,
**CONSUMER ACTION LAW CENTRE**

**Gerard Brody** | Chief Executive Officer

[10] Exploring regulatory approaches to consumer vulnerability: a report for the Australian Energy Regulator, page 22.

# APPENDIX A - SUMMARY OF RECOMMENDATIONS

**RECOMMENDATION 1.** Remove the allowance for bad debt expenses due to the COVID-19 pandemic from the VDO.

**RECOMMENDATION 2.** Undertake a thorough review of the bad debt costs that were added onto the 2021 VDO and refund customers if necessary .

**RECOMMENDATION 3.** The Commission should consider developing guidance to provide clarity around when discretion will be used to allow additional items to the VDO cost stack.

**RECOMMENDATION 4.** The Commission pursue measures that would lead to decreasing costs including introduction of a productivity factor in the 2022 VDO.

**RECOMMENDATION 5.** The Commission should incorporate approaches that ensure wholesale price benchmarks align with actual costs faced by retailers.

**RECOMMENDATION 6.** The Commission should cross check modelled wholesale costs including hedging against observed data on retailer costs. Where a range exists, efficient costs should be presumed in the first instance to sit at the low end of the range.

**RECOMMENDATION 7.** The Commission should conduct independent modelling as to an appropriate benchmark for efficient retail operating margin and set the allowance at the lowest point of any range given.

**RECOMMENDATION 8.** There should be no additional allowance for five-minute settlement.

**RECOMMENDATION 9.** Calculation of distribution and marginal loss factors should factor in increasing distributed energy generation which should offset losses.