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

Draft Victorian Default Offer 2023-24 – Public version

EnergyAustralia is one of Australia's largest energy companies with around 2.4 million electricity and gas accounts in NSW, Victoria, Queensland, South Australia, and the Australian Capital Territory. EnergyAustralia owns, contracts, and operates a diversified energy generation portfolio that includes coal, gas, battery storage, demand response, solar, and wind assets. Combined, these assets comprise more than 5,000 MW of generation capacity.

EnergyAustralia appreciates the opportunity to provide this submission to the Essential Services Commission's (ESC) Consultation Paper on the Victorian Default Offer 2023-24.

Our main issue with the draft VDO is around the inconsistent approach on the treatment of options relevant to setting the wholesale electricity cost. While we accept the exclusion of options for the final VDO, we strongly recommend that for future decisions the ESC incorporate the use of options in line with the DMO approach with some necessary changes.

We also raise some other issues regarding the retail cost categories and recommend the ESC undertake analysis on past VDO decisions against retailers' reported cost stacks to test the VDO's overall approach and whether the VDO price allows retailers to recover their efficient costs.

Our full submission is below.

1. Wholesale electricity cost methodology

1.1. Treatment of option contracts

The VDO's draft decision is to direct Frontier to exclude the data covering the day options expire from the calculation of the trade-weighted price.

Under the current approach, this data was included and the trades resulting from exercised options factored into the weighting of the settlement price, used to calculate the wholesale electricity cost in the VDO. We would prefer the ESC kept a consistent approach to the VDO generally to provide certainty to Retailers on what the VDO price will be. We also note that the proposed change has a negative impact on the WEC's trade weighted price [ ], resulting in a lower VDO compared to the current approach. This lack of consistency could be perceived as being aimed to produce lower price outcomes for customers.

That said, we recognise that the current approach has shortcomings and a degree of inaccuracy. Specifically, it included option volumes in the trade weighted price, but the use of options was not actually reflected in the VDO's Retailer hedging strategy.

We recommend that the ESC incorporate the use of options in the VDO's wholesale electricity cost methodology, in line with what the AER has proposed for Draft DMO5 but with a few necessary changes to improve accuracy. Draft DMO5's approach is appropriate because it reflects real world, prudent retailer practices. Some retailers have recently turned to using more options in their hedging strategy because of illiquidity issues in buying swap products. This illiquidity is due to sellers not selling because of generator reliability issues, increased ASX margin calls late last year, and other factors etc.

The AER's draft decision is to include base futures that are traded as a result of exercising base options in the wholesale methodology for DMO5. Specifically, the WEC will include the exercised options at the trade weighted average strike price plus the trade weighted average premium attached to the exercised and unexercised options.

The AER's approach is broadly reasonable but we consider there are necessary changes to improve accuracy as detailed in full in our extract of our DMO submission (attached). The main change we recommend is that the AER makes adjustments to exclude the volume of options traded for speculative purposes only and in particular the AER should exclude the impact of spread option trades. Our preferred and more accurate approach would be for the AER to evaluate the change in open interest in the same underlying swap product for the days the swaptions expire (in May and November), instead of a trade weighted approach.

2. Retail operating cost and margin

2.1. Retail operating cost (ROC) methodology

The ESC's new methodology of using retailers' actual cost data to calculate the ROC benchmark has decreased the benchmark by around $19 in real terms when compared to the benchmark under the current VDO. This lower provision in the VDO is inconsistent with increasing costs given the general rise in market risk occurring in 2022 and the state of retail competition reflecting a more volatile cost environment.

The use of a customer weighted average of retailers' operating costs, may mean smaller retailers with fewer customers and higher costs under-recover their costs as costs from larger retailers with more customers are allocated more weighting. This might have a detrimental impact on their retail viability over time. Further, the new approach may not provide as much incentive for retailers to reduce retail operating costs compared to the status quo.

We also note the inconsistency in not using retailers' actual costs regarding customer acquisition and retention (CARC). Retailers who spend to compete for customers should be allowed to recover these costs as they operate in a competitive market so these costs should be considered efficient. While we are not suggesting that the ESC must change the existing approach to CARC, given the inconsistency in approaches across the cost stack, we recommend the ESC examine the total VDO cost stack against retailers' reported cost data. This is discussed more below.

3. ESC should check past VDO decisions with retailers' costs to test overall VDO approach

We recommend the ESC undertake retrospective analysis on past VDO decisions against retailers' reported cost data for the relevant period when the data becomes available (i.e check FY24 VDO with retailer cost stack data for FY24). We support the ESC's continued checks that cost items are within the range of actual retailer costs; however, we consider a more holistic examination of retailers' total cost stack against past VDO cost stacks can be useful not to mention timely given the ESC has been collecting retailer data for several years.

Although past VDO decisions are not by financial year and reported retailer cost data is, comparison is still reasonable given both are based on annualised costs per customer. The ESC should at least undertake comparisons of the VDO total cost stacks for decisions covering the financial year period against retailers' reported costs for the same financial year. While the ESC is not obliged to consider retailer's actual costs under the pricing order when setting the VDO, this analysis can provide further insight as to the overall appropriateness of the VDO approach and the various cost stack components.

For example, we would expect that if the ESC observed a trend that all retailers' environmental costs differed significantly from the environment cost amounts set by the VDO for the relevant period then this would reflect the need to re-examine the appropriateness of the methodology for calculating environmental costs. The concept of an efficient retailer and the costs that can be recovered should fit within the realm of possibility in the existing market, and not reflect costs that an efficient retailer can recover in a notional market. This corresponds with our comments from previous submissions on the mix of approaches in setting individual cost items of the VDO in isolation, without clear regard to whether they align conceptually in method or in reality.

The ESC should build on this set of data to ensure the appropriateness of the VDO over time. We have undertaken analysis comparing past VDO cost stacks against our reported costs to the ESC over the relevant period.

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Lastly, we accept the ESC's decision to maintain consistency and use the retail operating margin of 5.7% adopted in previous VDO decisions. While the ESC considers the retail operating margin accounts for D&A we recommend that the ESC test it is sufficient to cover larger retailers with significant levels of capital investment and depreciation for their IT assets. As above, doing this overtime will allow the ESC to assess the appropriateness of the existing retail margin.

4. Market intervention costs

We support the ESC's approach to include known market intervention costs in the VDO for 2023-24 prices, noting that some market intervention cost will not be known before the final VDO decision. We support actions taken by the ESC to estimate these residual costs based on all the available information to allow them to be captured under the final VDO for FY2023-24.

5. Future approach to consultation papers

Finally, we support the ESC's approach to future consultation papers, replacing them with a 'request for comment' notice at the start of ESC reviews, and only publishing a consultation paper if the ESC is considering significant changes, **including changes to Frontier's methodology**.

If you have any questions in relation to our submission, please contact me (Selena.liu@energyaustralia.com.au or 03 9060 0761).

Yours sincerely,

Selena Liu
Regulatory Affairs Lead

Extract of DMO submission on Options issue

1. Wholesale electricity cost methodology

1.1. Use of Options in the DMO's hedging profile

The AER's draft decision is to include base futures that are traded as a result of exercising base options in the wholesale methodology for DMO5. This is to reflect the use of options in a risk averse retailer's hedging strategy. Specifically, the WEC will include the exercised options at the trade weighted average strike price plus the trade weighted average premium attached to the exercised and expired options.

To support its change in WEC methodology, the AER observes that "the volume of base options has increased significantly in the last 5 years. We anticipate the use of options as a hedging tool will continue to increase, as retailers revise their spot market risk management strategies". ACIL Allen notes that exercised base options contribute about 15 per cent of the traded volume of base 2023-24 contracts, and the increase in use of options over the last 12-18 months.

We observe that some retailers have recently turned to using more options in their hedging strategy because of illiquidity issues in buying swap products. This illiquidity is due to sellers not selling because of generator reliability issues, increased ASX margin calls late last year, and other factors etc.

Although there has been some increase in use, the increases in the volume of base options observed by the AER and ACIL Allen might still be also due to higher levels of speculative trading incentivised by volatile prices, rather than increased Retailer use for hedging purposes. i.e. The 15% of traded volumes appears too high for hedging purposes.

Overall however, we generally accept the AER's change in methodology but with adjustments. The AER's proposed change is, on balance, more accurate than the status quo. The AER should implement the following adjustments however before it adopts its proposal for final DMO5:

- **Trade weighted vs open interest -** It is important that the AER attempts to exclude the volumes of options traded for speculative purposes only and in particular the AER should exclude the impact of spread option trades. For example, a trader might simultaneously buy a 10MW $60 strike call for $5 and at the same time sell a 10MW $80 strike call for $1.50. Assume those options are exercised. The AER's trade-based approach would factor this 20 MW as weighting the strike price (by $5 and $1.50) which would be factored into the WEC. However, in reality, the trader has a net zero hedge position. Ultimately they have not acquired any incremental MW volume to hedge any customer load.

  The more accurate approach would be for the AER to evaluate the change in open interest in the same underlying swap product for the days the swaptions expire (in May and November), instead of a trade weighted approach. Change in open interest could be applied for both contracts traded from call options and those traded independent of options. This approach should provide a better proxy of the "net" position.

  If the AER fails to adjust for speculative trades, it could result in a significant under-recovery in WEC costs in a rising market. That is, it would overstate the impact of call options traded at a lower strike price compared to the settlement/market price. Note the reverse does not apply to average out the effect over time. i.e. it will not result in an over-recovery in a falling market, as a falling market will mean the options are "out of the money" (strike price above market price) and so the option will not be exercised in the first place i.e. no trades will occur to inflate the WEC.

- **Option premium -** We agree with the AER in including the cost premium attached to exercised and expired options.

- **Inclusion of financial year options that expire in mid-May** – ACIL Allen's methodology on options will include the calendar year options that expire in mid-November. However, it is unclear if financial year options that expire in mid-May will be included as this depends on whether ACIL Allen draws their ASX data for their final WEC calculation in time. The AER must include both calendar year and financial year options for their WEC to be accurate. If it can only include calendar year, then the better approach would be to exclude both and revert back to the status quo approach taken in the WEC.

- **Put options** – We question whether the new methodology will cover both call and put options. Put options should have limited impact, given the majority of options bought by Retailers for hedging purposes are call options.

- **Continued assessment of whether the new approach is appropriate** – We accept that the AER's changes are more accurate than the status quo and that current practice justifies the change. However it is still unclear how material the trend towards options is, how long it will last, and whether changing the methodology permanently is warranted in the longer term. The AER should continue to assess these matters after DMO5.