20 October 2020

Ms Kate Symons
Chair
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne Victoria 3000

Email: VDO@esc.vic.gov.au

Dear Ms Symons

RE: Victorian Default Offer 2021 Draft Decision

Origin Energy appreciates the opportunity to provide a submission in response to the Essential Services Commission's (ESC) Victorian Default Offer (VDO) 2021 Draft Decision.

The most significant challenge for the ESC in setting the VDO for 2021 is how to address costs incurred as a result of COVID-19. Retailers are faced with an environment of economic dislocation with customers experiencing increasing payment difficulty. At the same time retailers are expected, at least in the short term, not to disconnect customers for non-payment. Because retailers carry the cash-flow risk for the entire supply, this creates a situation where retailers are incurring ongoing costs without matching revenue streams to meet those costs.

As Government assistance measures reduce or cease, we expect a further deterioration in payment arrears and bad debt. It is vital that the ESC's VDO decision for 2021 balance the risks faced by retailers with providing ongoing price protections for customers.

The ESC is not alone in addressing this challenge. There have been recent reviews in the United Kingdom contemplating the treatment of COVID debt costs in a regulated price scenario. This issue has also been contemplated by the Australian Energy Regulator (AER) in its recent network deferral rule change and the Australian Energy Market Commission's (AEMC) energy competition review.

We believe Ofgem's views on how to treat COVID debt-related costs in its price cap warrant consideration in the Victorian context. Specifically, Ofgem's preferred approach is to treat COVID debt costs separately to other existing cost elements. This means that it does not need to amend individual cost stack allowance methodologies; rather it is an adjustment to recognise an extraordinary cost. Ofgem also purposes setting a "float" based on an estimate of debt-related costs for inclusion in the price cap and then having a "true-up" in a subsequent price decision.

We believe this approach has merit. It partitions COVID costs keeping the VDO formula clean. Because of this isolation, the ESC can treat COVID costs separately and transparently meaning retailers are only compensated for the incremental costs incurred. We discuss this method further in our submission, but on balance we believe it has the potential to address many of the risk we are currently wrestling with.

In terms of other elements of the ESC's draft decision, we do not consider that given the uncertainty of the current environment the introduction of a productivity measure is appropriate. Furthermore, the ESC's current retail operating cost data relies on costs data from the Independent Competition and Regulatory Commission's 2017 standing offer price review, which in turns relies on a benchmarking study performed by IPART from its 2012/13 standing offer prices decision. We believe that a productivity measure should be undertaken when there is less uncertainty in the operating environment, when the

ESC has more reliable data, and in the context of an incentive based regulatory regime that has symmetrical rewards and penalties as occurs in network regulation.

Origin's responses to specific matters raised by the ESC are set out below.

COVID-Related Costs

COVID-19 has created a situation where retailers could be financially pressed between customers who are unable to pay their electricity bills, and the retailers' own obligations to pay wholesale and network energy charges. As noted by the AER, in these circumstances it is imperative that retailers do not bear the financial burden of COVID-19 alone.[1]

Furthermore, retailers are expected, at least in the short term, not to disconnect customers for non-payment, further amplifying this risk.

As Ernst & Young noted in its report to the ESC, COVID-19 is likely to be a significant enough impact on the cost stack in 2021, that the Commission should consider its options for adjusting the VDO calculation to take into account the impacts of COVID-19 on retailers' costs in 2021.[2]

A significant challenge for the ESC is that there is a time-lag in the data which means we may not be seeing an accurate reflection of current or future debt levels. Most small customers pay for their electricity consumption quarterly in arrears, which creates a natural lag between broader economic conditions, and the cash position of retailers. Additionally, there is a further time-lag from a customer missing a payment, to it entering a hardship program, and the debt being categorised as bad debt.

As a result, the ESC must strike a balance in its regulatory approach between ensuring retailers are appropriately compensated for carrying the cash flow risk of the supply chain with a mechanism that does not overcompensate retailers because of the lack of data available today.

Ofgem recently considered this challenge in its *Reviewing the potential impact of COVID-19 on the default tariff cap.*[3]

Like the Australian market, the UK has implemented several measures to help industry and consumers manage the impacts including reprioritising the forward regulatory work programme to allow the industry to focus on their critical operations and deferral of certain network charges. In terms of assessing debt-related COVID costs, Ofgem's overarching consideration was to only make changes where there are clear and material systematic impacts of COVID-19 on the costs of supplying default tariff customers that are not appropriately accounted for by the existing cap methodology. We think this is consistent with the current Victoria context.

Ofgem's initial view is that its underlying cap methodology is still appropriate, and that the impacts of COVID-19 should be considered separately to the existing allowances, i.e. on-top of the existing cap level, rather than creating or removing entirely new categories of cost or fundamentally changing the structure of specific costs. [4]

As Ofgem note, COVID-19 has changed costs in the price cap formula. The question is whether the existing cap methodology sufficiently accounts for these changes. Some changes could be covered by existing uncertainty allowances and prudent assumptions in the cap methodology, while other COVID-

---

[1] AER, Request for rule change – extension of time for retailers to pay networks, May 2020, p. 2.

[2] Ernst & Young, Impact of COVID-19 on the, efficient costs for retailers to supply electricity, Interim report Essential Services Commission, 28 August, p.34.

[3] Ofgem, Reviewing the potential impact of COVID-10 on the default tariff cap: September 2020 policy consultation, OFG1161.

[4] Ofgem, p. 15.

19 impacts may have materially and systematically changed costs compared to the allowance, and the cap should be adjusted cap accordingly. [5]

Ofgem also noted that debt-related costs[6] have changed sufficiently due to COVID19 (either as a one-off or on an ongoing basis) and that not changing the cap would result in a clear and material systematic departure from efficient costs. [7]

After considering several options, Ofgem considered that where the impact of COVID-19 on a cost is either extended over time (for example, if it is linked to an economic recession) or where timely accurate actual data is not available, it would prefer an ex post approach, but recognise that a float and true-up approach may be more appropriate. This may be appropriate for some debt-related costs, where the final cost will only be known when a supplier has exhausted recovery options and written off the debt. [8]

Ofgem describe the ex post and float options as follows:[9]

> *Ex post: use the actual costs incurred, once the data is available. The advantage of this approach is that we would have the best possible understanding of the costs. The disadvantage is that such clarity may take time to emerge, particularly for costs with a very long lag time, such as bad debt write-off. In the meantime, there could be a discrepancy between a supplier's costs and the allowances in the cap, which could lead to cashflow pressures for suppliers;*
>
> *A 'float': include an approximate value in the cap period where the costs should be incurred, based on the best information available at that time. We would then 'true-up' the difference between the approximate value and a better estimate or actual value, once more information is available. This approach can better align the cap value to costs incurred in a specific time period, if a reasonable approximation can be made. This approach also relies on being able to implement the true-up in an unbiased way, including where the true-up is not in suppliers' favour. Otherwise, this approach would risk becoming too high on average...*

The ESC has expressed concern around the uncertainty of costs as a result of COVID. It has stated that due to the high level of uncertainty around projections of bad debt it considers that there is insufficient justification to increase the retail operating cost benchmark because customers should not pay more to reflect uncertainty about the impacts of the pandemic on bad debts and retailer costs.[10]

We agree that customers should not pay more than efficient costs. However, retailers should not bear all the cash flow risk of this uncertainty. As the AEMC notes, the impacts of, and restrictions associated with, COVID-19 are likely to increase consumer energy debt and in turn reduce retailer revenue.[11] As stated, the challenge is striking a balance between retailer risk and customer costs. We believe Ofgem's float and true up model can address this balance.

We recognise that there will be challenges in establishing a float and true-up when there are potential lags between a regulatory allowance and when true costs are known. Notwithstanding, we think this could be managed by the ESC by:

- using the bad and doubtful debt allowance from its 2020 decision as a base;

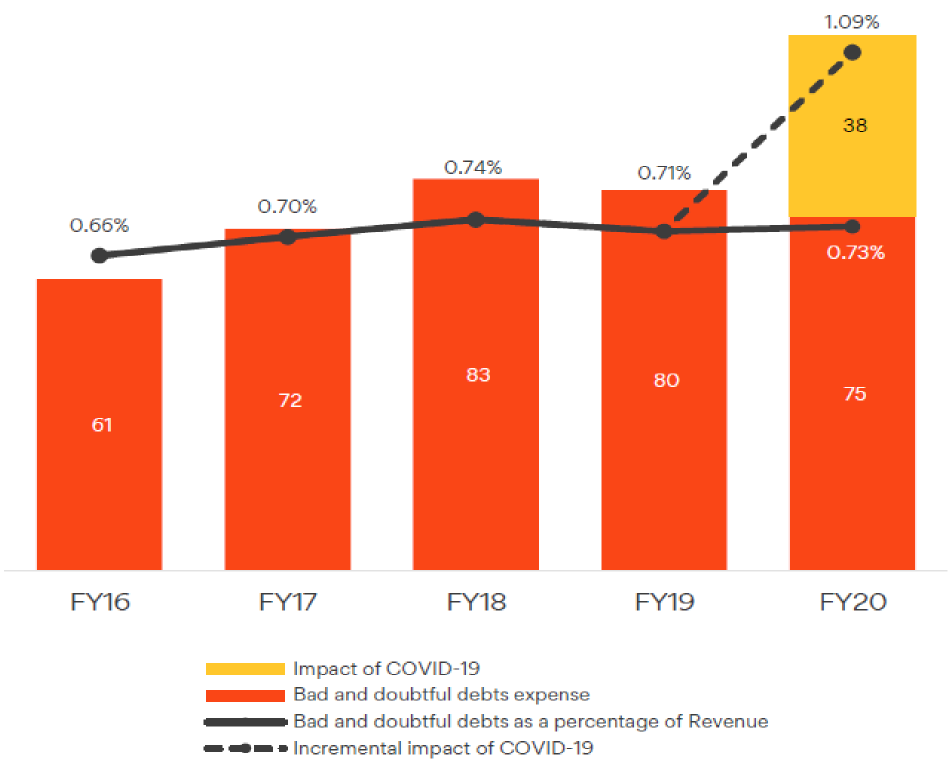
[5] Ofgem, pp. 15-16.
[6] Debt related costs are defined as: increasing working capital costs due to late payment; increasing bad debt costs due to non-payment; and additional administrative costs associated with recovering doubtful debt.
[7] Ofgem, p. 17.
[8] Ofgem, p. 23.
[9] Ofgem, p. 22.
[10] ESC, p. 26.
[11] AEMC, Rule determination, Deferral of network charges, 6 August 2020, p. i.

- establishing an initially conservative float based on the latest available actual data and its judgment;
- having clearly defined definitions around what constitutes a bad debt for the purposes of the true-up and how and when retailers are expected to provide this data; and
- setting a simple and transparent equation for determine the ex post true-up.

In terms of demonstrating the material need for such a mechanism to apply in the 2021 decision, Origin has recognised an additional non-cash provision of bad and doubtful debts (BDD) associated with the potential impacts of COVID-19 on customers' ability to pay their energy bills of $38M; of which $25M is attributed SME and residential customers. This provision covers outstanding amounts for customers up to 30 June 2020 and is in addition to the amount already set aside for bad and doubtful debts. While this figure covers Origin's customer base, we believe that a Victorian specific value could be made using customer numbers as an allocator.

As shown in diagram 1, this represents a significant uplift in BDD in terms of both an aggregate value and as a percent of total revenue.

Diagram 1: Origin Bad and Doubtful Debts



We believe the provision value represent a useful base for the ESC to make a judgment regarding a float allowance. We would welcome the opportunity to work more closely with the ESC to better understand the type and format of data the ESC would require to better inform a judgment about a BDD allowances.

Retail Costs

The ESC has determined an allowance for retail operating costs per customer based on the benchmark of $121.07 set by the Independent Competition and Regulatory Commission in its 2017 final decision for retail electricity prices in the Australian Capital Territory. This is consistent with previous years. The ESC has adjusted this benchmark for the change in the consumer price index (CPI) since 2017 which leads to a benchmark of $125.12. In addition to this benchmark, the ESC has set an allowance for additional regulatory costs and Victoria specific operating costs of $10.

The ESC previously indicated that it uses the Australian Bureau of Statistics Consumer Price Index (CPI) (All Groups, Original) to update the data.[12] In its draft decision, the ESC has applied a negative CPI rate of -0.8 per cent to index retail operating costs. We understand the ESC has used the difference between the ABS index value for the June 2020 quarter and the index value used in its last VDO determination.

Origin considers that the percentage change in the consumer price index for any relevant *year t* should be determined using the following formula, populated with the Australian Bureau of Statistics all groups index for the weighted average of eight capital cities.

$$\Delta CPIt = \frac{CPIJune(t-2)\ +\ CPISept(t-1)\ +\ CPIDec(t-1)\ +\ CPIMarch(t-1)}{CPIJune(t-3)\ +\ CPISept(t-2)\ +\ CPIDec(t-2)\ +\ CPIMarch(t-2)} - 1$$

This methodology is consistent with that used by the Independent Competition and Regulatory Commission to determine standing offer prices for the supply of electricity to small customers.[13] Origin considers that this method is preferable to an annual quarter on quarter estimate since the outcome is not overly influenced by movements in the index during a single quarter. That is, the estimate is effectively smoothed and therefore more representative of the change in the CPI over the preceding year.

Productivity Allowance

The ESC noted that there is publicly available evidence that electricity retailers have achieved substantial savings in costs to serve in recent years, with further savings forecast. For this reason, the ESC has flagged the prospect of introducing a productivity factor in future reviews.

We do not consider that given the uncertainty of the current environment, the introduction of a productivity measure is appropriate. Furthermore, the ESC's current retail operating cost data relies on costs data from the Independent Competition and Regulatory Commission 2017 standing offer price review, which in turns relies on a benchmarking study performed by IPART from its 2012/13 standing offer prices decision.

Origin's cost to serve increased significantly in 2018 in response to the Prime Minister's intervention and a mixture of mandated and encouraged measures. For example, Origin's externally reported cost to serve increased from $541M in FY17 to $624M in FY18. The additional activity and effort driven by these measures drove an unsustainable level of cost increases. In response, Origin announced a $100M cost reduction program. Observed reductions in recent years have not yet returned costs back to pre-intervention levels with FY19 being $610M and FY20 being $572M.

We would argue therefore that as costs remain above pre-2018 levels, there are no savings to be shared.

Furthermore, we believe that a productivity measure should be undertaken when there is less uncertainty in the operating environment, when the ESC has more reliable data, and in the context of

[12] Essential Services Commission, 2019, Victorian Default Offer to apply from 1 January 2020: Draft decision, September, p.50.
[13] ICRC, 2020, Price Direction 2020-24 Supply of electricity to small customers, June, p.8.

an incentive based regulatory regime that has symmetrical rewards and penalties as occurs in network regulation.

Wholesale Energy Costs
The ESC has again engaged Frontier Economics to estimate wholesale energy costs (WEC). Frontier has applied a method consistent with previous calculations.

We retain our view from previous submissions that regulated businesses should be provided with a reasonable opportunity to recover at least the efficient costs they incur in providing services and complying with regulatory obligations. We direct the ESC to arguments put forward in our previous submissions that Frontier's approach of taking the 50th percentile does not meet this regulatory standard.

Network Costs
In the past, electricity distribution networks in Victoria have had their tariffs determined by the AER on a calendar year basis. However, the Victorian Government has directed the networks to change to a financial year pricing arrangement.

Under the proposed transition, the network businesses submitted network prices to the AER on 13 October 2020, for the six-month period 1 January 2021 to 30 June 2021. The networks will then need to submit annual network prices for 2021/22 to the AER by 30 March 2021.

To address this timing issue, the ESC proposes to treat any difference in the network tariffs it has used for the VDO and the final tariffs approved by the AER for 2021/22 as a cost pass through to the VDO in July 2021. We believe it is vital that the ESC ensures that retail businesses are not exposed to a situation where the network costs that have been allowed for in the VDO do not cover retailers' actual network costs. This occurred in the AER's DMO decision for 2019/20 and resulted in a significant financial detriment to retailers.

Length of the Regulatory Period
The ESC has stated that the 2021 VDO regulatory period should be for 12 months and that the future VDO determinations ought to align with the Victorian electricity and gas network business regulatory periods which will run on a calendar year basis from 1 July 2021. To enable this alignment, the next VDO decision will need to be for either six months or 18 months.

We also believe that a shortened timeframe of six months to the next VDO decision could provide the ESC with a better understanding of COVID-19 impacts and that these impacts could also be considered when network costs are updated at July 2021. We believe this could be captured under a variation mechanism.

We look forward to working closely and cooperatively to support the ESC in its 2021 determination.

If you have any questions regarding this submission, please contact Sean Greenup in the first instance on (07) 3867 0620.

Yours sincerely

Keith Robertson
General Manager, Regulatory Policy

Origin Energy Limited ABN 30 000 051 696• Level 32, Tower 1, 100 Barangaroo Avenue, Barangaroo NSW 2000
GPO Box 5376, Barangaroo NSW 2000 • Telephone (02) 8345 5000 • Facsimile (02) 9252 9244 • www.originenergy.com.au