21 July 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 Consultation Paper

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

The impact of COVID-19 poses a major challenge for electricity retailers, consumers and regulators. There is likely to be a significant increase in the number of residential and small business customers experiencing financial distress and we are committed to providing real and targeted support to assist those of our customers who need it through this period. However, to do this effectively we need confidence the VDO regulatory framework will allow retailers to recover additional costs incurred because of COVID-19, so we can continue to focus on the delivery of services and support to our customers.

The current situation is far from business as usual and we consider it critical that the ESC acknowledge that the 2021 VDO will be fundamentally different to previous years as a consequence. In developing the 2021 VDO, we consider it vital that the ESC take into account the changed operating conditions and the inherent cost and risk implications this presents to retailers.

The regulatory measures to assist electricity customers during the pandemic, such as the AER and ESC's "Statement of Expectations", have had a significant impact on the retail operating environment and the relationship between retailer and customer; in particular, the ability of retailers to make objective business decisions has been partially subsumed by the need to provide increased customer support.

As a result, retailers are facing higher ongoing costs through more frequent calls and longer average call handling times with customers, increases in customer payment cycles, and growing bad and doubtful debts. The challenge for the ESC is in striking the right balance between short-term pricing outcomes for customers and maintaining the financial viability of retailers and the competitiveness of the sector. Failure to get this balance right could have long-term adverse impacts on customers as a result of reduced retail competition.

In undertaking its calculation of the VDO for 2021, we consider it essential that the ESC:

- recognise the fundamental shift in the retail operating environment presented by COVID-19 and associated customer relief measures;
- adjust the retail operating cost allowance and retail margin to adequately incorporate the increased non-systematic and systematic risk to support the ongoing financial viability of retailers; and
- balance the short-term impact on customers (prices) with the impact on retailers and retail competition to ensure that long-term customer benefits are not compromised.

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

Wholesale Electricity Costs
The ESC has advised that it intends to adopt the same method from its previous VDO decisions to calculate the wholesale cost allowance. We retain our concerns raised in the ESC's 2020 review, in particular:

- taking the 95th percentile of the wholesale electricity costs (rather than the ESC's choice of the median) reduces the risk that the ESC does not underestimate the wholesale electricity costs for retailers;
- the need for greater transparency of the STRIKE Model with respect to how "scaling" is undertaken; and
- disagree with the approach of subtracting a contract premium before pool prices are scaled.

In addition, for the 2020 VDO, the ESC used ASX Energy contract prices for base and peak swaps, and $300 caps for the 12 months up to 25 October 2019. We consider that when the ESC determines prices for 2021, that it ought to maintain a consistent approach and apply trading data from October 2019 to October 2020.

We note that during the pandemic, residential demand has increased by about five per cent weather adjusted and that SME demand has decreased close to 20 per cent. This illustrates the need for conservatism in estimating hedging costs.

Network Costs
The ESC proposes using the simplest underlying network tariff for each distribution zone as the structure for the respective VDO in each network, generally a daily supply charge and a flat usage charge. We support this approach.

We note that the AER will approve the 2021 tariff proposals for Victoria's electricity networks (to commence 1 January 2021) in mid-November 2020. Origin is strongly of the view that final approved network charges should be a direct pass through and be reflected in the ESC's final decision, regardless of which transition approach it adopts to a financial year VDO.

Environmental Costs
The ESC considers it appropriate to retain the same approaches to estimating environmental costs and other regulatory costs, updating for the most recent available data where necessary and possible.

For LRET costs, the ESC proposes to determine these as the loss adjusted electricity multiplied by futures market prices and by the Clean Energy Regulator's (CER) renewable power percentage with an upper bound of the penalty rate. Origin considers the proposed approach is again reasonable for 2021.

In relation to the Small-scale Renewable Energy Scheme, the ESC acknowledges the difference between the forecast small-scale technology percentage and the binding small-scale technology percentage published by the CER. For the 2020 VDO the ESC adopted the mid-point of the 2020 non-binding small scale technology percentage and 2019 binding small-scale technology percentage. While Origin considers this represents a pragmatic approach under the circumstances, we suggest the ESC consult with the CER on how to derive a more up to date estimate for inclusion in the ESC's analysis to reduce the compounding impacts of variances in following years. We also consider that the ESC ought to consider a true-up where the there is a reasonable difference between its allowance and actual costs.

Retail Costs
The ESC has asked retailers how COVID has impacted retail operating costs and what approaches it should take to quantify these impacts.

We believe that the impact of COVID has and will largely manifest in bad and doubtful debts (BDD) and increased economy wide risk (systematic).

Bad and Doubtful Debts

The 2020 VDO made an allowance for retail operating costs (excluding customer acquisition and retention costs) using a benchmarking approach from the Independent Competition and Regulatory Commission (of the ACT) in 2017. The ESC indicates that it intends to adopt a similar benchmarking approach for the 2021 VDO, using retailer data as a cross-check against the benchmark.

The ESC indicates that it will update its data set by collecting cost data for the 2018-19 financial year from retailers. However, the 2018-19 data will not incorporate COVID-19 impacts. Furthermore, we do not expect COVID impacts to fully start to emerge until later in 2020 when the major Government support measures (Job Keeper and Job Seeker) transition to lower support rates. For instance, JobSeeker support payments will reduce by $300 a fortnight from September 2020. The JobKeeper program will be split into two tiers, with people working more than 20 hours a fortnight having their payments reduced by $300 a fortnight in September ($1500 to $1200) and then a further $200 a fortnight in January 2021 ($1200 to $1000). For those working less than 20 hours a week the reduction will be $750 a fortnight in September (from $1500 to $750), and by a further $100 a fortnight in January ($750 to $650). These are considerable reductions at a time when energy bills often increase to meet air-conditioning over summer.

We are concerned the benchmarking approach proposed by the ESC to determine retail operating costs, including a provision for bad and doubtful debts, is no longer fit for purpose in the current environment. Any benchmark determined by the ESC will not incorporate COVID-19 impacts and therefore will not be reflective of costs facing retailers or costs of the "efficient retailer".

To highlight this, Origin has recently announced that we expect to recognise an additional non-cash provision of bad and doubtful debts associated with the potential impacts of COVID-19 on customers' ability to pay their energy bills of between $25M and $35M. 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.[1]

As stated, the ability of retailers to make objective business decisions has been partially subsumed by the need to provide increased customer support. As a result, we believe that increasing BDD and extended payment arrangements will become a persistent issue for retailers.

It is incumbent upon the ESC to capture costs as a result of COVID-19 in the retail cost allowance. Failure to incorporate the legitimate costs incurred by retailers would be unfair to retailers and inconsistent with the requirement to determine efficient retailer costs as set out in the pricing order. To the extent that the forward-looking impact of these costs are unknown, we consider that the ESC should provide a reasonable estimate and provide a mechanism for recovering these costs once information becomes available. Where the cost allowance is insufficient to provide for recovery of these unanticipated costs, the retail margin would need to be revised to reflect the increased risk with this operating environment.

Retail Margin

While the ESC indicates it is aware that COVID-19 will have an effect on the finances of both retailers and their customers, the ESC proposes to retain the same benchmarking approach to setting an allowance for retail operating margin from the current VDO.

[1] https://www.originenergy.com.au/about/investors-media/media-centre/origin_expects_to_recognise_non_cash_charges_in_fy2020.html

The consultation paper highlights the current competitiveness of the Victorian retail market and the implications for setting the retail margin. The ESC suggests any assessment of competitiveness reflects pre-COVID-19 conditions. In order to maintain this competitiveness, it is important for the ESC to carefully consider how it sets a margin that reflects the current and prospective economic and regulatory environment facing retailers.

The basic premise underlying the estimate of an appropriate retail margin is that the expected returns to equity holders should reflect the systematic risk of those returns. This premise is the basis for the setting of almost every regulated price in Australia. Systematic risk is reflective of exposure to overall economic or market conditions. As stated by the AEMC:

> *A robust and effective retail margin must be capable of responding to changes in market conditions. If the allowed retail margin is not determined with regard to the prevailing market conditions, it will either be above or below the return that is required by capital market investors at the time of the determination. Neither of these outcomes is efficient, nor in the long-term interests of customers.*[2]

The recent AEMC *Retail Energy Competition Review* highlighted the increased risks facing the retail electricity sector as a result of the COVID-19 situation. The AEMC noted that electricity retailers carry the credit and cash-flow risks for the entire electricity sector, yet on average only about 15 per cent of a customer's bill is the retailer component.[3] As a consequence, an increase in late and non-payment of energy bills, combined with the increased regulatory obligations to continue to supply customers with electricity, is likely to have significant consequences for the financial stability of retailers. The AEMC also highlighted the increased risk of financial contagion as a result of the Retailer of Last Resort (ROLR) process. Specifically, the AEMC indicates that the inability to disconnect non-paying customers means that:

> *… a number of retailers may fail, and as the proportion of customers who are not paying their bills on time concentrates with the ROLR, the risk for broader financial contagion and market risk increases.*[4]

Origin recognises that some bad debt/default is a normal part of doing business. These normal business risks are allocated to retailers and addressed in setting the retail operating cost allowance. However, COVID-19 has created a systematic risk for the energy sector through an expected material increase in customer defaults and bad debts (above business as usual) due to a deterioration in economic conditions. Consistent with regulatory practice, systematic risk should be allocated to retailers in setting the retail margin.[5] IPART notes that a material increase in customer defaults and bad debts due to changes in economic conditions represents an increase in systematic risk and should be included in the retail margin.[6]

Origin considers it vital that the ESC adequately incorporate the increased systematic risk faced by retailers in the retail margin to ensure the ongoing financial viability of retailers and to maintain competition in the retail sector. While Origin appreciates the difficulties facing customers at this time, it is important that the ESC balance the short-term impact on customers (prices) with the impact on retailers and retail competition to ensure that long-term customer benefits are not compromised.

While we appreciate that the ESC's role is the calculation of the VDO, there are a number of alternative approaches to dealing with COVID-19 related costs such as:

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[2] AEMC, 2013, Final Report Advice on best practice retail price methodology, 27 September, p.68.
[3] AEMC, 2020, *2020 Retail Energy Competition Review*, June, p.137.
[4] Ibid., p.153.
[5] See for example Frontier Economics, 2019, *Retail Costs and Margin – A Report for the Essential Services Commission*, February.
[6] IPART, 2010, *Review of regulated retail tariffs and charges for electricity 2010-2013 – Final Report*, p.55.

- a more equitable sharing of bad debts with network businesses. For example, networks could rebate retailers for the network component of the retailers' bad debt for the duration of the pandemic less an agreed percentage reflecting the retailers' business as usual level of bad debt. The networks could then recover an agreed percentage of this rebate under their existing regulatory mechanisms as a cost from a regulatory change event. Retailers would wear business as usual bad debt plus all non-network costs of non-business as usual bad debt (i.e. non-network COVID-19 related bad debt). This approach ensures both networks and retailers share losses more equitably and would reduce the overall cost of bad debt included in the VDO; and/or
- direct government payments to retailers to account for COVID-19 cost impacts. For example, the Queensland Government's Household Utility Payment of $200 for residential customers and $500 for small businesses has proven effective in providing bill relief for Queensland customers which we expect will translate into more manageable electricity bills.

The advantage of these alternative approaches is that they provide retailer/customer support without introducing increased retail sector risk and avoid the potential unintended consequences associated with managing these costs through regulated retail prices. We understand these provisions are outside of the ESC's remit. However, we strongly urge the ESC to work with Government to consider these support measures.

<u>Other Costs</u>

Origin considers that the ESC will need to consider whether COVID-19 and associated government support initiatives could result in a sustained increase in operating costs. For example, costs associated with administering hardship programs and more frequent and longer average handling times through our call centres. We are concerned given the time horizon of the data request these costs will not be fully considered in the determination of the VDO.

The ESC assumes that the introduction of five-minute settlements would be delayed to 1 July 2022 and therefore no allowance is required in the 2021 VDO. However, the recent AEMC Final Decision ultimately concluded that a 12-month delay would not be appropriate and determined that a delay of only three months will be provided. Accordingly, the ESC will need to consider how the implementation of five-minute settlements will impact retailers' costs.

Length of the regulatory period

From 2021, the approval of network prices will move from calendar year approvals to financial year approvals. In response, the ESC proposes to align the VDO with the financial year network pricing process. The ESC has proposed a number of options for when this alignment should occur.

Origin agrees that the timing of regulated retail prices and regulated networks tariffs should be aligned. While there are additional costs and administrative issues for retailers and customers associated with changing retail electricity prices, we consider that a 6-month VDO for the period 1 January 2021 to 30 June 2021 is a lower risk approach in the circumstances.

The shortened timeframe will provide alignment with the network pricing process and will also allow for better understanding of COVID-19 impacts and costs to be captured in a July 2021 decision. However, this would mean that customers would receive two price changes in the space of six months; and especially a price change over the Christmas/New Year period. To ensure a continuity of prices, another option would be to extend the current VDO for six months to 30 June 2021. This may be administratively simpler and provide customers with ongoing price certainty as well as providing an additional six months to obtain information and data of the impacts of COVID before making a decision of its impacts. To the extent that there are material differences between actual and allowed costs over the six-month period January to June 2020, this could be trued up in the VDO to apply in 2021-22.

Variation mechanism

Origin considers that the proposed variation mechanism is an appropriate means of addressing unforeseen changes in costs during 2021, particularly those associated with COVID-19. We consider that the mechanism should be applied where the impacts on margin are material but request that the ESC clearly define the term “material” and its application.

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
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