

Victoria Energy Policy Centre

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Essential Services Commission of Victoria

By email: VDO@esc.vic.gov.au

Dear Madam/Sir

SUBMISSION ON 2023/24 Draft Victorian Default Offer

Thank you for the opportunity to make a written submission on your draft decision and for accepting this late submission. In media commentary I have suggested the ESC should “think again”, comments which I expanded upon in the consultation forum the ESC hosted. In this submission I expand on some aspects of these comments.

My main point is to draw attention to the fact that the cost of producing the vast bulk of the electricity that is sold in Victoria has remained stable, relative to the large changes in observed markets prices whether measured as spot prices or the prices of contracts. These “market” prices reflect changes at the margin and are driven by factors elsewhere – mainly the price of gas and black coal.

In the market arrangements that exist in Victoria these prices give rise to a gap between the cost of supply for those generator/retailers that access Victorian electricity production, particularly from brown coal, and that are able to sell that production in wholesale spot or contract markets at the observed prices.

This gap may also be expressed in the market for the sale of electricity to small customers and is likely to be significantly affected by the VDO. This will clearly be the case for customers supplied at VDO rates, but the VDO is also likely to significantly affect offers that retailers voluntarily make (on the basis that the VDO is perceived to be endorsed by the Government it becomes an important reference price).

This difference in cost and price gives rise to questions of policy. On this, it strikes me that both the Australian Government and the Victorian Government have to varying degrees rejected market-determined prices, and have capped inputs (gas and coal prices) in the case of the Australian Government and have adopted policies – such as the re-creation of the State Electricity Commission – which seek to deliver price outcomes that are closer to production costs.

In this context, I think the ESC is inevitably in the position of having to decide whether to set a VDO in line with its perception of wholesale market prices in the context of the marginal clearing price construct, or whether to take account of policy decisions to deviate from that construct. In its Draft Decision the ESC has made a decision in line with the former. I think the ESC should place weight on the latter, consistent with policy decisions.

It might be suggested that ratcheting the VDO down so that the energy production component is brought down to be in line with weighted average costs rather than perceived wholesale market prices, would reduce “headroom” and so damage retail competition. It seems plausible to argue that it would reduce the attractiveness of the retail market to retailers (by reducing available profits) but this need not necessarily reduce the strength of rivalry in the market, and consequently the extent of innovation and learning. It is this innovation and learning that is after all what retail contestability is meant to deliver.

It is also not obvious to me the extent to which a tougher wholesale price allowance would be relatively more disadvantageous to new entrant retailers relative to the incumbent retailers who access brown coal production through ownership or long term contracts. While not necessarily a relevant factor in your decision, I note that it is likely to be the incumbent retailers that have, relatively, more to lose by bringing the wholesale price component of the VDO in line with weighted average production costs.

Finally, I note that the observation of prices in the market will always be contentious. Frontier Economics’s approach is not replicable for various reasons not least that it relies on their bespoke spot market prediction. More generally, different weights on financial contracts of different types and different durations can result in quite different price estimates. There is no objectively right way to predict future prices, it is a market after all. I think that this too should be weighed when considering the merits of placing greater reliance on weighted average production costs in the determination of the energy price component of the VDO.

I would be pleased to discuss this further at your convenience.

Yours sincerely,

Bruce Mountain,
Director