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Essential Services Commission
L37, 2 Lonsdale Street
Melbourne, Victoria 3000

Lodged via email: retailenergyreview@esc.vic.gov.au

Dear Commissioners

RE: ESC Victorian Default Offer to apply from January 2020

ERM Power Retail Pty Ltd (ERM Power) welcomes the opportunity to respond to the issues paper on the Victorian Default Offer to apply from January 2020 (the paper).

About ERM Power Retail

ERM Power Retail Pty Ltd, which trades as ERM Power, is a subsidiary of ERM Power Limited, an Australian energy company operating electricity sales, generation and energy solutions businesses. Since launching in 2007, ERM Power has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load[1], with operations in every state and the Australian Capital Territory. ERM Power has increasing success in the small business market. www.ermpower.com.au

General Comments

ERM Power is deeply concerned about the timeframes provided to the Commission and question the ability of the Commission to undertake a methodical and well analysed approach in prescribing time of use standing offer tariffs to apply from 1 January 2020, with a price determination by 25th November 2019. The assumptions behind segmenting customers to time of use tariffs to create regulated standing offers, particularly those applying to small business, is highly complex. We are concerned that the VDOs implementation is being rushed and will lack the rigour of adequate consultation to ensure that time of use tariffs are carefully designed and cost reflective, bringing confidence to participants and the paying consumer.

This compressed timeframe not only puts an unrealistic expectation on the regulator to have formed a careful and considered analysis of costs, but also for retailers to amend prices and create documents for the numerous tariffs. Getting the assumptions wrong results in ill-conceived and inappropriate tariffs that place unmanageable risks on retailers who are then unable to operate economically, and this leads to irreparably harming the competitive market. We believe that a cautious and conservative approach to setting these tariffs is warranted.

The Commission has indicated that it will have regard to the efficient costs a retailer incurs when purchasing from the wholesale market to meet its customers' demand. ERM Power strongly encourages the Commission to consider that the approach to wholesale contracting may differ greatly between smaller and vertically integrated or larger retailers. In its projection of efficient wholesale costs, the Commission must contemplate the likely approach smaller and new entrant retailers will prudently take in seeking to minimise residual volumetric risk. In constructing a least-cost hedging portfolio, particularly for time of use customers, the more likely path for smaller retailers may

1 Based on ERM Power analysis of latest published financial information.

be to mitigate market risk through full load flex products, such as load following hedges. These are likely to come at a premium to the forward price but are essential for the efficient risk management for such retailers. There is little doubt that any regulated price will effectively form a cap in market, and so setting a price that relies solely on the definition of efficient retailer to be that of a large vertically integrated retailer, and ignoring the prudent hedging approach of smaller retailers, risks harming competition. Taking a broader approach to hedging strategies when determining efficient wholesale costs will reduce the likelihood of the VDO being set at a level that will only allow the incumbent, dominant retailers to operate economically in the market.

Given the inevitability of this regulated price to be setting a cap for the market, we appeal to the Commission to consider the impact of its pricing decision on those customers that do not fit the assumed norm of a small business customer. The regulatory framework in Victoria continues to ignore the approach of efficient contracting and service delivery of multi-site arrangements, and the Commission should consider the impact of creating a maximum annual bill for a small site that may normally be contracted as part of a larger conglomerate. Further, the current regulations of imposing information requirements of maximum bill quantities (annual estimates) on price change notices and alike misleads such customers, when their normal approach is to contract as part of a multi-site group and leverage the pricing arrangements of a large customer.

Finally, the complexity of time of use tariffs for small business customers due to the variability of this customer type, should not be underestimated or dismissed. It is our experience that these customers do have more complex usage patterns and may be on network tariffs structures that encompass demand pricing elements. Further, by its averaging approach, the Commission may overlook the significance of customers that lie outside of its average bands. We believe the Commission must utilise an approach that minimises the risk of creating two customer groups, one of customers that fit the average, and those that frequently exceed maximum annual price thresholds, purely due to the inherent variable nature of their consumption, making them 'outliers'. Retailers who service these customers should not be penalised by having to undertake costly administration of refunding exceedance to the maximum annual bill amount, purely due to the narrowed benchmarks provided through the VDO. We suggest that a more flexible approach to minimise this occurrence when setting the maximum bill amount is paramount, and we discuss our recommendation of using customer consumption profiles in the following pages.

I would welcome the opportunity to discuss this submission in detail.

Yours sincerely,

[signed]

Libby Hawker

Senior Manager, Regulatory Affairs

[redacted]

Approach to wholesale electricity costs

Hedging Instruments

Wholesale contracting is the risk management tool that underpins the service that retailers provide to customers. Retailers use hedging strategies to manage the risk of spot market volatility while ensuring customer prices are set at affordable levels. The dilemma for the Commission is to define what is 'an efficient cost' of purchasing wholesale energy for a retailer to meet its customers' demand, when retailers have such divergent approaches depending on their risk appetite and accessibility to the wholesale contract market with different funding costs and credit risk profiles.

Although the Commission has indicated that it will maintain its existing approach of estimating wholesale costs, including utilising ASX energy contract prices, we urge the Commission to consider that many smaller retailers may enter the market and prudently manage their load risk (which, depending on their targeted customer group may be peakier in load shape) through the use of load flex hedging products. In fact, it is not uncommon for retailers to manage the volumetric risk of time of use customers by using load following instruments. Often OTC load following products come at a significant premium (approximately 30%) to flat products - including exchange traded derivatives. For those small retailers that engage counterparties to seek to reduce their prudential costs of AEMO acquisitions through reallocation, often load following hedges are a prerequisite to procure such arrangements. Smaller and new entrant retailers may be more likely to enter into contracts that are not flat ASX traded products, and the Commission must accommodate for this approach in determining 'an efficient cost'. This will be critical for such retailers so that they may have an ability to transact, pass through reflective costs to their customers and that they can continue to participate in the competitive market.

Contract expiry timing

In determining the least-cost hedging portfolio, we urge the Commission to consider the likely timing of procurement for small business customers. It is well known that most business customers contract to calendar or financial year periods. Retailers are therefore more likely to be seeking wholesale contracts for customers who are shifting to standing offers at the expiry of their contract, at times of higher wholesale pricing. This makes the small business procurement quite different from residential procurement and the lumpiness of load required to be hedged over summer and winter must be considered.

Other market changes must be considered

ERM Power notes the Commission has indicated that it is proposing to not consider the Retailer Reliability Obligation costs for the regulatory period beginning 1 January 2020. We suggest that any triggering of the obligation in the short term, albeit with a gap period in late 2022, will change the landscape of wholesale costs and consideration should be given towards the latter half of 2020. This may be coupled with changes to the availability of other hedging products such as caps, which may be limited through the introduction of a five-minute market in 2021. With an expectation of a tighter cap market because of the reduction in availability of cap products offered by generators unable to meet dispatch within five minutes, and an increase of demand for firm type products, wholesale costs are likely to rise. Such regulatory changes should not be dismissed by the Commission.

Determining a VDO compliant maximum annual bill

Determining the VDO for small business standing offer customers with non-flat tariffs or a combination of a flat and non-flat tariff is highly complex. Small businesses have variable and unpredictable load patterns and may often incorporate demand tariff elements. In determining a maximum annual electricity bill amount the Commission must accommodate those customers that are outliers to the average. If the price does not accommodate these customers and their usage results in frequent exceedance of the cap, they will become 'higher costs to serve' customers, with greater chance of requiring post billing adjustments. Frequent adjustments are not a great customer experience.

In the paper, the Commission has provided two options to the approach of calculating the maximum annual bill. We see issues with both approaches, noting that the second approach is favored by the Commission. Operationally, using the flat tariff to define the cap for a range of consumption levels will still result in a significant number of customers frequently breaching the cap. Those customers that are peak or demand heavy, lie outside the averaged load shape of flat tariffs. Time of use tariffs are generally designed to somewhat align with flat tariffs on a specific average customer load shape. However, this will mean that some customers benefit with greater consumption in off peak times whilst paying more if they are peak heavy. If the cap is set by aligning to an average linear volume of usage, it is probable that a vast number of customers will frequently breach the cap and require some form of compensation.

Of greatest concern in this scenario, is that retailers will not know if customers have breached the cap until after billing has occurred. Dealing with compensation and adjustments at this stage is costly. Further at this point it is too late to try and move the customer onto a flat standing offer tariff. Distributors are unlikely to perform network tariff reassignments retrospectively in order to align retailer tariffs to network costs.

It is important to remember that it is the distributor that assigns network tariffs, not the retailer. The suggestion that retailers simply withdraw their non-flat standing tariffs and only offer non-flat tariffs to market customers grossly oversimplifies how tariffs are set and ignores the fact that tariffs are assigned by distributors. Any misalignment in network tariffs to retail standing tariffs will result in significant losses to the retailer. It is also important to understand that whilst retailers can move customers from time of use tariffs back to flat tariffs if they exceed the cap, retailers would require the networks to do this at the same time which is not always achievable. Networks are not compelled to make tariff reassignments, and in any case are unlikely to undertake frequent tariff reassignments for the one customer. Further, for those customers that have capacity contract obligations, tariff reassignments are often unobtainable. For these reasons the options are unwieldy and onerous to implement and places the retailer at unacceptable risk.

Utilising customer load profiles

ERM Power suggests that the approach least likely to cause distortions and harm would be to set the maximum bill based on a specific customer profile. The profile could be calculated by looking at an average customer and their typical allocation of peak / off peak. This would provide flexibility and accommodate for a wider range of customers.

For example, the Commission could set rates on one set profile at peak 60% and off peak at 40% and any demand at 2.5 times the average demand. Under this approach, any variation in customer usage for a specific customer type is unlikely to result in exceedance. This methodology was suggested by the AER for the Default Market Offer. It is more likely to lead to an outcome that is workable and accommodates a greater variability in load of small business customers.

An example of this approach, for an average SME with usage of 20MWh:

The maximum annual bill = 12MWh*Peak + 8MWh*Off Peak +365*Daily Charge+ 20/8760*2.5*Demand