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Price Monitoring and Regulation
Essential Services Commission
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Email: RetailEnergyReview@esc.vic.gov.au

Dear Essential Services Commission

Victorian Default Offer to apply from 1 January 2020

Meridian Energy Australia Pty Ltd and Powershop Australia Pty Ltd (MEA Group or Powershop) thanks the Essential Services Commission (ESC) for the opportunity to provide comments on the ESC's Issues Paper concerning the application of the Victorian Default Offer (VDO) from 1 January 2020 (the Paper).

Background on the MEA Group

MEA Group is a vertically integrated generator and retailer focused entirely on renewable generation. We opened our portfolio of generation assets with the Mt Millar Wind Farm in South Australia, followed by the Mt Mercer Wind Farm in Victoria. In early 2018 we acquired the Hume, Burrinjuck and Keepit hydroelectric power stations, further expanding our modes of generation. We have supplemented our asset portfolio by entering into a number of power purchase agreements with other renewable generators, and through this investment in new generation we have continued to support Australia's transition to renewable energy.

Powershop is an innovative retailer committed to providing lower prices for customers and which recognises the benefits to customers in transitioning to a more distributed and renewable-based energy system. Over the last five years, Powershop has introduced a number of significant, innovative and customer-centric initiatives into the Victorian market, including the first mobile app that allows customers to monitor their usage, a peer-to-peer solar trading trial and a successful customer-led demand response program. Powershop has also been active in supporting community energy initiatives, including providing operational and market services for the community-owned Hepburn Wind Farm, supporting the Warburton hydro project, and funding a large range of community and social enterprise energy projects through our Your Community Energy program.

General feedback

As per our previous submissions to the ESC, Powershop does not support the proposed methodology for setting the 1 January 2020 VDO. We consider that the proposed methodology is likely to have an adverse impact on all Victorian customers in terms of price, access to competitive and innovative offers, and reliability. Further, it is highly likely to reduce innovation, have a significant impact on customer service and the investment in required renewable generation in Victoria, and trigger a decline in competition across the entire Victorian energy sector, with corresponding detrimental consumer outcomes.

Wholesale Costs

Powershop notes that the ESC does not plan to alter its approach to the wholesale electricity cost component of the cost stack in setting the VDO for 2020. Powershop does not agree with this approach, consistent with our previous submissions and those of various other participants. Specifically, there are a number of key issues that remain unresolved:

- Regarding the estimation of consumption load data, Powershop encourages the ESC to incorporate the most recent data available in its analysis of consumption load data, to reflect the changing risk of increased hedging costs due to the higher ratio of peak to average load and a higher load variance. This is especially important to allow for and harmonise with other Victorian Government policy initiatives, including for example the Solar Homes Package.

  Powershop would also appreciate if the ESC could clarify what data period will be used for 2020. The Paper notes that the "final advice used data over a two-year period, splitting it by domestic and small business customers with consumption less than 40 MWh per year",[1] whereas the draft advice stated "that the five years from 1 July 2012 to 30 June 2017 provide reasonable data for forecasting load and price expectations for 2019-20".[2]

- The theoretical, academic model used for the 1 July 2019 VDO did not consider the actual costs that are incurred by a retailer. In calculating and determining the wholesale component of the 1 January 2020 VDO, the ESC should test the model against historical outcomes and identify the real-world costs and the practical hedging practices of a prudent retailer. For example, the methodology should take into account that retailers have significant fluctuations in customer numbers throughout the year, creating a volume forecast risk for most non-Tier 1 retailers.

- In a rising wholesale market, there may be increased demand from consumers transferring from market offers (who may, potentially, be on a 12-month fixed price contract) to the VDO price. This may result in retailers incurring losses for transferring customers, even alongside effective hedging practices. Retailers will also be required to hold greater amounts of capital for such periods, resulting in increased financing and hedging costs which will ultimately be borne by consumers who currently have the benefit of market rates below the proposed VDO.

- The ESC needs to define how peak demand is defined in the 1 January 2020 VDO as this was not evident in the Frontier Economics approach. Many retailers hedge to maximum historical demand to avoid excessive capital exposures and cash flow complexities associated with more-extreme market events. Powershop's position remains that "the ESC should be cognisant of the fact that many retailers are required to be risk-averse and cannot reasonably be expected to incur excessive costs associated with not hedging to at least historical peak demands".[3]

- The ESC must allow for volume and price variance between years in the estimation of the efficient wholesale costs of a retailer using historical load and price data calculation. This approach would recognise that our costs are higher in higher demand years with higher prices in peak periods when compared to the average year.

- The 1 January 2020 VDO must take the Retailer Reliability Obligation (RRO) into consideration, in particular the requirement for retailers to be hedged to their one in two forecast peak demand one year in advance of a reliability gap period. Frontier Economics has incorrectly assumed that hedges are entered into 6 months prior to taking effect. In practice, a prudent, efficient retailer would enter into hedges to meet the RRO obligations in the 6-12 month period prior to it taking effect, in total and on average 18 months prior.

  We note that the RRO commenced on 1 July 2019, and is therefore already a consideration in retailers' cost stacks.

Network losses

When determining the 2020 VDO, the ESC must take into consideration that the network loss factors will change during that VDO period.

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[1] Essential Services Commission Victorian Default Offer to apply from 1 January 2020, 23 July 2019, Page 10

[2] Essential Services Commission Victorian Default Offer to apply from 1 July 2019 Draft advice, 8 March 2019, Page 22

[3] Victorian Default Offer to apply from 1 July 2019 - MEA Group Submission, 4 April 2019, Page 5

Please find below our responses to the questions raised in the Paper.

Are there other issues – such as more complex tariff structures, we should consider in calculating network costs? How should these be resolved?

Utilising flat network tariffs for the 1 July 2019 VDO (for simplicity) ignored the joint government and industry drive towards more cost reflective tariffs and to improve energy consumption behaviour. The 1 January 2020 VDO must ensure that cost reflective tariffs are strongly considered and incentivise customers to change their consumption behaviours. The VDO should not require retailers or non-VDO customers to carry the risk of bearing a greater proportion of network costs and cross-subsidising VDO customers as a consequence of applying an inefficient methodology.

Does this cover all environmental and other costs?

Powershop has provided feedback in relation to the RRO in our general comments, above. Further to this, the ESC should also take into account that the Clean Energy Regulator sets the renewable percentage targets typically in February of each calendar year.

Have any major changes occurred to retail operating costs since May 2019 when we submitted our final advice to Government? If so, what is the nature and magnitude of these changes?

The recent suite of regulatory changes that have been implemented in Victoria, especially in relation to differences with the national framework, have significantly added to cost and the complexity of our operations. This includes updates to website content and structure, customer billing and other system changes, call centre training, marketing and other collateral, and increased legal and regulatory burden. Further regulatory changes in Victoria and the NEM will only increase these costs.

We support the development of a formal request approach from the ESC to complement and support the ESC's position of continuing with a benchmarking approach to estimate these costs. We anticipate that receiving retailer cost data will reduce the reliance on historical regulatory benchmarks and set appropriate retail operating costs on real, up to date data. However, any retailer data received by the ESC needs to be properly analysed and assessed, taking into account the submitting retailer's cost base, strategy and market positioning.

Are there any new sources of data that we should consider to estimate a modest allowance for customer acquisition and retention costs?

Powershop was disappointed that the ESC did not implement modest customer acquisition and retention costs (CARC) for the 1 July 2019 VDO, and in doing so failed to follow the Fair Pricing in the Energy Market – Terms of Reference for the Essential Services Commission (ToR).

For the 1 July 2019 VDO, the ESC failed to price CARC on the basis of existing marketing standards and approaches and instead relied on Australian Competition Consumer Commission (ACCC) average data and a small allowance for Victorian regulatory costs. This dataset was substantially out of date and failed to include the significant increases in costs we have incurred since that data was submitted.

Powershop does not believe that 'new sources of data' are the only criteria to reconsider in estimating a modest CARC. Powershop encourages the ESC to ensure that its upcoming formal request (referred to above) is aligned to the current ACCC data requests for existing Victorian practices. The ESC must also base the CARC on current marketing standards and approaches, as required under the ToR.

Are there other issues we should consider in determining retail operating margin?

The impact of the ESC setting a low retail operating margin (since 1 July 2019) has validated our concerns that Victorians may no longer access many of the benefits or financial incentives that were previously available in the market. By setting a low operating margin, and not providing any allowance for innovation and investment, the ESC is reducing the incentive for retailers to improve customer service and product offering and choice.

A further consequence to not providing an operating margin is that pricing of offers may simply converge to the VDO, stifling the required initiative to transition to a renewables market, as desired by the Victorian Government.

How could we resolve these issues in determining VDO tariffs for the first regulatory period (1 January 2020 to 31 December 2020)?

The 1 July 2019 VDO has achieved its key outcome of providing a fair offer for disengaged customers on standing offers. The 1 January 2020 retailer operating margin must incentivise customer participation in the market, and provide customers a broader choice of offers and products to what is now available.

In what circumstances should the commission consider, and on what basis should the commission decide on, a proposed variation to a VDO price determination?

Powershop believes that the VDO must be flexible enough to adapt to volatile pricing events (e.g. wholesale costs, supply events, network costs). Indeed, the VDO should embrace the same practices a retailer is required to adopt to accommodate cost changes, and be cost reflective based on material market movements. Such flexibility will be critical to ensuring competition in the market and customer choice.

Are there any other options we should consider when determining the VDO compliant maximum annual bill that continues to meet the requirements of the order?

Powershop understands that the ESC is subject to tight timeframes for meeting the Victorian Government's objectives in relation to non-flat tariffs. Notwithstanding these demands, it is imperative that the ESC takes a careful approach in determining the VDO compliant maximum annual bill. Powershop would prefer the ESC determine a robust methodology in order to set VDO rates for all non-flat tariffs. If this cannot be achieved in the timeframe available, the ESC should either delay the implementation, or adopt a similar approach to that used by the Australian Energy Regulator in setting the Default Market Offer.

Powershop encourages the ESC to monitor and report on the impact of the initial VDO, and other new regulations, to determine whether the VDO is working and should continue, or if the re-setting of standing offer amounts and the new regulations are sufficient to meet the Victorian Government's objectives.

Noting the limited timeframes the ESC is under to re-set the VDO, Powershop suggests adopting a cautious, considered and measured approach, mindful always of the need to reduce the potential impacts on prices, competition, innovation and investment. We encourage the ESC to seriously consider the potentially significant adverse effects of any changes on Victorian consumers, the energy market and ultimately the Victorian economy.

We look forward to working with the ESC on setting an appropriate VDO for 1 January 2020. If you have any queries or would like to discuss any aspect of this submission please do not hesitate to contact me.

Yours sincerely,

Ed McM

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