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**Re: Victorian Default Offer 2021 Consultation Paper**

Dear Commission:

GloBird Energy welcomes the opportunity to provide important feedback on the VDO to apply in 2021.

In the [FINAL REPORT 2020 RETAIL ENERGY COMPETITION REVIEW<sup>1</sup>](#), the AEMC note “Electricity retailing is a relatively high-volume, low-margin industry”, and the average retail operating margin is a mere \$4 for every \$100 of revenue. On the other hand, based on the “[Victorian Default offer to apply from 1 January 2020, Final decision 18 November 2019](#)”<sup>2</sup> by ESC, the allowed retailer operating margin is 5.7%, which is \$5.70 for every \$100 of revenue. Both reports confirm the fact that the maximum net profit an energy retailer could make is quite modest.

GloBird makes the point that given the tight margins, it would create an issue of viability for retailers, if regulators fail to accurately forecast and appropriately account for costs when setting the regulated price. This is even more important in Victoria compared to other jurisdictions due to its unique regulatory requirements.

Best Offer, Restrictions on how often price changes can occur, and using the VDO as a reference for discounts have removed the retailer’s ability to increase price based on the latest market movements and charge customers an amount above the VDO, even for customers on market offers. From July 2020, retailers can only increase the customer price once per year. Also, the Best Offer requires that every three months, a retailer must compare the customer’s current electricity offer to all other public offers, including the VDO. It must advise the customer if they could save \$22 or more per year by switching to the VDO or another market offer. The retailer cannot withhold the VDO from customers who demand it. This means that once set, the VDO price is effectively the ceiling price a retailer could charge its customers.

Since the introduction of the VDO in July 2019, two VDO prices were released and a full year passed with a VDO in place. It is now possible and in-fact beneficial to compare the actual cost retailers have incurred against the predicted cost defined in the VDO. Particularly the WEC, and any regulatory & compliance related costs, to see if they are valid in today’s market. Both of these costs are out of the retailer’s control. In addition, the recent pandemic has impacted all stakeholders and highlighted that it is retailers who burden most of the risk in the energy supply chain. This should be taken into consideration when setting the VDO price for 2021.

With this in mind, GloBird provides the following answers to some of the questions asked in the “[Victorian Default Offer 2021 consultation paper 16 June 2020](#)”<sup>3</sup> issued by the commission.

**Question: Are there any changes or issues we need to consider about the underlying data we use to calculate wholesale electricity costs? In particular, changes to volume or patterns of consumption due to COVID-19 that might extend into the 2021 calendar year?**

**GloBird Response:**

- 1. Based on GloBird’s actual customer load profile, the past WEC calculated by the model is below what an efficient retailer could achieve. We strongly urge the Commission and Frontier to back test with the last financial year’s real data and review its model and key assumptions to ensure the derived WEC & its Load Premium are realistically achievable by a prudent and efficient retailer**
- 2. Hedge & AEMO prudential funding cost (more than \$9.16 per residential customer per year) was not but should be included in the WEC**
- 3. The difference between the forecasted and actual ancillary service fees (of \$5.34 per residential customer per year) should be considered in the VDO 2021 as true-up**
- 4. GloBird fully supports the AEC’s proposal to adopt the 95th percentile WEC as the final estimate to cater for the difference between a theoretically optimized but incomplete and under-costed model and the real-world result.**

Since the shutdown of Hazelwood, Victoria has moved rapidly towards a lower carbon economy with more renewable energy in the mix to replace the old baseload coal power plants. While this is the right direction, due to its intermittent nature, a more intermittent generation has increased risk and volatility in the wholesale spot market. Extreme prices are seen more often in summer. And compared to NSW, Victoria’s wholesale market is now more volatile with a much higher energy cost on average. This can be seen from the higher ASX energy futures price in VIC compared to NSW. Furthermore, increased rooftop solar panel uptake has created a spot market phenomenon known as the “Duck Curve”, where the daytime spot prices have become unusually low and often below zero when solar is generating, but the early morning and evening prices are much higher. This is more noticeable in the winter months and means retailers incur a higher wholesale risk management cost. A higher wholesale price, a more volatile spot market and a more obvious Duck Curve phenomenon means the VIC Wholesale Energy Cost is naturally higher than before the Hazelwood shutdown, and is higher than NSW, which we will touch on further in this submission.

Load Premium measures the difference between the actual cost compared to the ideal flat average price. It is the clearest indicator to compare volatility and the hedging effectiveness between different approaches and models. Load Premium is calculated using the load and time-weighted average wholesale energy cost in \$/MWh divided by the average spot price of the same period. Based on the papers published by the ESC & AER for the VDO & DMO WEC model, GloBird has extracted the WEC and the futures market price used in setting the VDO & DMO to calculate the Load Premium for residential profiles. We also calculated the Spot Market Load Premium using our own Victorian customer’s load profile for the last two financial years. To ensure the Load Premium is not skewed by GloBird’s hedging practises, the calculation excludes any hedging contracts and is based on 100% spot market pool price and demand exposure. Since most of GloBird’s customers are residential customers, our comparison is focused solely on the residential VDO & WEC.

The results are show in the table below.

Hedge Product	VIC VDO July 2019	VIC VDO Jan 2020	NSW DMO 2020/2021	Comment	
Q1 Futures Base Swap (\$/MW)	\$104.54	\$130.45	\$85.57	VIC is for FY20 and calculated using 366 days a year. NSW is for FY21 and calculated using 365 days a year	
Q2 Futures Base Swap (\$/MW)	\$73.16	\$85.19	\$63.89		
Q3 Futures Base Swap (\$/MW)	\$84.42	\$78.57	\$71.55		
Q4 Futures Base Swap (\$/MW)	\$74.55	\$77.50	\$83.02		
<b>Annualized Futures Base Swap (\$/MW)</b>	<b>\$84.14</b>	<b>\$92.85</b>	<b>\$75.99</b>		
Q2 Futures Caps (\$/MW)	\$28.99	\$39.81	\$19.47		
Q2 Futures Caps (\$/MW)	\$3.57	\$3.26	\$4.12		
Q3 Futures Caps (\$/MW)	\$3.35	\$3.50	\$4.40		
Q4 Futures Caps (\$/MW)	\$5.51	\$6.37	\$7.29		
<b>Annualized Futures Cap Price (\$/MW)</b>	<b>\$10.32</b>	<b>\$13.19</b>	<b>\$8.77</b>		
VIC AGL	\$105.29	\$121.33			Wholesale Energy Cost at Regional Reference Node, before Network Loss factor
CitiPower	\$103.05	\$118.11			
TXU	\$108.57	\$126.28			
PowerCor	\$103.56	\$119.20			
United	\$108.91	\$127.27			
AusGrid			\$100.92		
Endeavour			\$101.07		
Essential			\$93.84		
<b>Average Residential VDO or DMO WEC for all distribution areas (\$/MWh)</b>	<b>\$105.88</b>	<b>\$122.44</b>	<b>\$98.61</b>		
<b>VDO Residential /DMO WEC Load Premium</b>	<b>125.8%</b>	<b>131.9%</b>	<b>129.8%</b>	Average of all distribution zones	
Average Spot Price – July 2019 to June 2020 (\$/MWh)		\$73.74	\$71.95		
GloBird's VIC Spot Market Load Premium when NOT hedged (July 2018 to June 2019) \$/MWh		132.9%		This includes a small number of business customer related WEC. If excluded, the actual residential only Load Premium would be higher.	
GloBird's VIC Spot Market Load Premium when NOT hedged (July 2019 to June 2020) \$/MWh		132.3%			

Table 1: WEC Load Premium Comparison – VDO & DMO

Source of Data:

1. [Consultant report: Frontier Economics - Wholesale electricity costs \(final report\)](#)
2. [Consultant report: Frontier Economics – Wholesale electricity and environmental costs for final decision \(final report\)](#)
3. [ACIL Allen - DMO 2020-21 Final Determination - Wholesale and environmental costs - 28 April 2020](#)
4. [Advice on the Victorian Default Offer to apply from 1 July 2019 to 31 December 2019](#)
5. [Victorian Default Offer to apply from 1 July 2019: Final advice](#)
6. [Victorian Default offer to apply form 1 January 2020, Final decision 18 November 2019.](#)

Based on the results above, while the VDO residential Load Premium appears to be slightly higher than the DMO by the figures, the real difference is the opposite when we consider the following differences in the two models:

- 1) The DMO WEC was developed using the net system load profile NSLP, which includes both residential and business customer's load. Based on the VDO 2020, the Load Premium for business customers is approximately 9% lower than the Residential customer's Load Premium. This means the inferred residential only Load Premium in NSW DMO would be even higher than the current DMO Load Premium. If we were to calculate a residential only WEC for DMO, the difference between VDO WEC Load Premium and the NSW DMO residential Load Premium would be much higher.
- 2) The NSW wholesale market is far less volatile compared to the VIC energy market due to its higher portion of base load generation, which can be seen from the much lower futures Cap contract prices in NSW compared to VIC.

Based on the differences between the two models, we can comfortably conclude that the Load Premium of VDO residential customers is lower than the implied Load Premium for NSW DMO residential customers, which is at odds with current market conditions. What's even more concerning about Frontier's WEC model is that the load premium in the VDO WEC is below what GloBird could achieve by running completely naked in the wholesale market (meaning not hedged at all) and instead be fully exposed to the wholesale market pool prices in both the last two financial years (July 2018 to June 2020). We suggest Frontier check and verify if the same result was to apply to the general market load profile using the latest VIC MRIM data from AEMO, as such a low Load Premium is totally un-realistic for any retailer to achieve. Because hedging will only increase the total wholesale Energy cost due to natural inefficiencies, which is caused by the mismatch between the hedge contract volume and the actual customer demand at any point in time.

In addition to the WEC, in the wholesale market, Prudentials are an elementary requirement of the wholesale market and should be included in the VDO. Both ASX energy futures market and AEMO require sufficient credit support for wholesale hedging and spot market settlement, as with any OTC contracts. In the DMO, ACIL Allen calculated the total "Hedge and pool prudential costs" for NSW is between \$1.66/MWh to \$2.25/MWh across three NSW distributors<sup>4</sup>. If we apply the average cost to Victoria, it is approximately \$9.16 (including GST) per residential customer per year on 4,000KWh of energy consumption after network losses. The number is expected to be higher in Victoria due to higher wholesale energy cost and higher volatility, and even higher for smaller retailers due to their greater funding cost. Given the miniscule margins, this is not a small figure that retailers can just swallow. After all, the retailers are also required to prepare funding upfront to pay for operating costs, office, employee costs, as well as paying network distributors, AEMO and other wholesale settlement in advance of any customer payment.

Furthermore, as stated in the ACIL Allen's report for DMO 2020/2021, the ancillary service recovery cost "has tripled (or increased by \$1.16/MWh) across all regions and tariff types"<sup>5</sup>, this is equivalent to approximately \$5.34 per customer per year on 4000KWh usage after network losses. Again, in GloBird's view, the difference should be added to the next VDO.



And finally, we have noted the ESC's view is that the median approach (the 50<sup>th</sup> percentile) better fits the requirements of the pricing order<sup>6</sup>. It is important to point out, the fact that the median result derived by the model is not necessary the average wholesale energy cost the retailer will be facing in the real-world.

First of all, the 50th percentile is only the median value but NOT necessary the mean value in the model. The WEC is generally skewed to the higher end under extreme circumstances, the loss to the retailers in these extreme years would likely be much more than the total gains in normal years. Therefore, the average result of all simulation is higher than the 50th percentile result.

Secondly, it is appropriate to be a little more conservative than the current VDO WEC model to provide some compensation for the difference between a theoretically optimized, incomplete and under-costed model compared to real-world experience. The model is purely hindsight-based, built on a small data set, without consideration of a number of real-world challenges, it also doesn't include any variations that can reasonably be expected to happen in the market, not to mention unexpected changes like the current pandemic. In detail:

- The Frontier WEC model is based on three years of historical data, which is a limited sample set, the pandemic is a good example to show an unexpected real-world occurrence.
- There are no considerations given to the natural customer churn rate (which is approximately 30% annualised), and its impact to retailer's hedging position and the associated cost. VDO customers are not subject to any contract termination fees, and for customers on market contracts, the maximum allowed early termination fee is \$22. This termination fee is insufficient to cover the financial loss a retailer experiences when closing out the hedge position. They are essentially now forced to buy, in order to provide the level of price certainty they are obliged to. This problem is particularly pronounced when the wholesale market movement drops \$50/MWh in a short few month as it has recently. Based on the assumed 4000KWh annual usage, the current retailer would suffer a financial loss of up to \$200 per residential customer, to close out the hedge contract for a churning customer or to reprice that customer based the latest wholesale cost when providing "best offer".
- The difference in customer demand forecasting, the actual hedge contract size and the actual customer demand in real time will never be a perfect match. The challenge is even bigger when we consider the customer churn rate and the ever-growing Duck Curve caused by solar.
- There are no considerations given to any demand-side settings, like the ones done by ACIL Allen in the DMO modelling. Which gives consideration to the "P10, P50 and P90 peak load, and energy forecasts from the AEMO neutral scenario to produce multiple simulated representations of the half hourly load profile for the given determination year using a Monte Carlo analysis". Also no consideration is given to any projected uptake of rooftop PV and their impact on demand.

- There are no considerations given to any “Supply side settings”, like the ones done by ACIL Allen in the DMO modelling, to consider the impact of any planned & committed changes to existing supply.
- There are no considerations given to extreme wholesale price movements that have happened in the pandemic. The model assumes the actual spot price outcome would be in line with the futures market’s settlement price, but in reality, the actual result could be under or over by up to \$80/MWh like what happened in Q1 20, where the Future Price prediction in Nov 2019 was \$150/MWh but the actual spot settlement price is less than \$78.84/MWh, the simulation completely ignores scenarios like this.
- The human related trading deviations retailers face in real life compared to a theoretical average trading result are ignored. Life would be wonderful if everything followed perfectly a theoretical mechanical simulation.

Considering these issues, it is highly likely the real-life WEC result will be higher than the model has simulated. To ensure the VDO is set on a reasonable WEC that an efficient energy retailer could possibly achieve, GloBird fully supports the point made in the AEC’s submission to adopt 95th percentile WEC as the final estimate. The extra room compared to 80<sup>th</sup> percentile WEC is helpful to cover some of the differences between the modelled WEC and the actual WEC retailer have to pay.

We urge the commission and Frontier to back test with broader market data, review the current WEC model and its key assumptions & metrics. This will ensure the derived WEC is realistically achievable by a prudent and efficient retailer in the current VIC energy wholesale market. We also ask that the prudential funding cost are included in the WEC and ancillary service fees are updated in the VDO. More importantly, we support adopting the 95th percentile WEC as the final estimate.

***Question: Should we consider any other approaches to accounting for the difference between the forecast and binding small-scale technology percentage?***

***GloBird Response:***

- 1. The difference between the forecasted VDO LRET & SRES cost compared to the actual cost (\$18.08 per residential customer) should be added into the VDO 2021, plus a small buffer for future variance.**
- 2. The Feed-in Tariff (Social cost of carbon) in VDO 2019 & 2020 should be checked based on actual rooftop solar generation data in FY 2020 with true-up being applied in VDO 2021, plus a small buffer for future variance.**

As highlighted by the commission in the draft report for VDO 2021, there are differences in the actual retailer cost compare to the forecasted retailer cost in the VDO on the “Environmental and Regulatory Costs”. In GloBird’s view, such a difference is inevitable in practise. GloBird suggest the commission be conservative and include a reasonable allowance on the estimation, then do a true up in the next VDO.

- In VDO 2020, the estimated RRP for LRET is 20.15% and STP is 14.56%, the actual declared RRP for LRET is 19.31% and STP is 24.4%, the actual LRET and SRES cost is

\$4.11/MWh higher before Network Losses, which is \$18.08 (include GST) per residential customer per year on the 4000KWh of annual usage. This again is not a small number that a retailer can absorb. We suggest the cost difference should be added in the VDO 2021, plus a small buffer in case the actual liability is again higher than the estimation in 2021.

- In the VDO, a social cost of carbon is included in the Solar Feed In tariff, which is costed at \$0.025/KWh of solar generation, and the total is estimated to be \$8.39/customer in VDO 2020. Since there has been a massive and rapid uptake of roof-top solar in recent years, the actual solar generation feed into the grid is much higher than the estimated solar generation in the VDO 2019 and VDO 2020. Based on GloBird's own customer profile, the actual cost should be \$13.67, the difference is 63% higher compared to the VDO 2020 estimation. Being a cost which retailers have absolutely no control over, and the rooftop solar generation will only increase in the near term, it is fair to the industry if the commission can update the actual cost between July 2019 and June 2020, and add the difference into the VDO 2021. Also add a small buffer, because the actual liability will definitely be higher than the estimation in 2021.

**Questions:**

**What impact has COVID-19 had on retail operating costs and for how long will it affect costs?**

**What approaches if any should we use to quantify the impacts (including any opposing changes)?**

**GloBird Response:**

The impact of COVID-19 has multiple impacts.

Firstly, it has increased the funding cost on retailers due to the credit crunch, which happens when lenders are reluctant to provide credit to business and demand a much higher risk premium in return. The cost of funding, to some retailers, is as high as 25% annualized for short term loans when the pandemic initially broke out.

Secondly, the customer's payment terms are stretched, this initially impacted small business customers more than residential customers, but with the increased un-employment rate, we expect the impact on households to increase slowly moving forward and will last up to 2 years, due the regulatory requirements on retailers to offer extended and tailored payment plans, as part of the Payment Difficulty Framework. One of the possible approaches to estimate the increase of bad debts, is to link it to the unemployment rate and assume for every 1% of increase in the un-employment rate, retailer would suffer the same level of increase on bad debts.

Thirdly, this increases the general operating costs, as the business is required to support employees working from home. Productivity is impacted with employees unable to interact and work from the one location and the systems it takes to support remote working .

Fourthly, during these uncertain times where many residential customers are forced to spend more time at home, customers use more energy and are generally more concerned about their bills and make more customer service related enquires. Retailers must spend more effort communicating with customers on usage enquiries, high bills, debts, billing related issues and stress, resulting in a

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higher cost to serve, this cost increase is not expected to reduce before the pandemic is fully under control.

Finally, the compliance reporting requirements during the pandemic have also increased significantly, resulting in a higher IT development and cost on compliance personal.

**Question: Should the commission change the length of the regulatory period beginning 1 January 2021 to 6 or 18 months? If so, what are the reasons for why we should make this change?****GloBird Response:**

GloBird recommends changing the next VDO price regulatory period to six months only. We understand this would result in more work for both the commission and the industry, however, the benefit outweighs this.

As we have experienced in the last three years, the wholesale market has become far more volatile since the Hazelwood Power Station shutdown, the massive increased uptake in rooftop solar panels and the increased mixture of renewable energy and their impact is yet to play out in the wholesale market. Also a more frequent update of the VDO will give the regulator and the industry an up to date picture of the wholesale market, help to provide a more accurate cost estimation, providing mutual benefit to all parties. On the other hand, the introduction of VDO and some other fundamental shift in the regulatory requirements will undoubtedly bring some underlying long-term changes to the market. More frequent VDO pricing will give the industry and regulators a chance to respond to those changes.

Sincerely



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