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Thursday, April 4, 2019

Dr Ron Ben-David
Chairperson
Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Dear Dr Ben-David

RE: Victorian Default Offer to apply from 1 July 2019 – Draft advice

ERM Power Limited (ERM Power) welcomes the opportunity to respond to the Essential Services Commission (ESC) draft advice on the Victorian Default Offer (VDO) to apply from 1 July 2019, which details a proposed methodology and recommends a price for the VDO.

About ERM Power

ERM Power is an Australian energy company operating electricity sales, generation and energy solutions businesses. The Company has grown to become the second largest electricity provider to commercial businesses and industrials in Australia by load¹. A growing range of energy solutions products and services are being delivered, including lighting and energy efficiency software and data analytics, to the Company's existing and new customer base. The Company operates 662 megawatts of low emission, gas-fired peaking power stations in Western Australia and Queensland. www.ermpower.com.au

General comments

The ESC is commended for providing an accessible statement of rationale for its determination of a VDO. It is understood the proposed legislation will limit the prices of standing offer contracts for residential and small business customers to a VDO, providing a regulated price that will replace standing offer prices. ERM Power acknowledges that although the VDO will be made available to all customers, retailers will be allowed the flexibility to provide market offers priced above and below the VDO.

The ESC has identified that the implementation of the VDO should result in a default price that is representative, reflecting costs incurred by efficient retail operations. The ESC has stated their aim of establishing a cost-based approach to establish reasonable estimates of costs to industry.

ERM Power believes there are a number of matters which are currently limiting the ESC's efforts to provide a representative default price. In order for a default price to fairly reflect the costs for retailers to service customers, ERM Power recommends the ESC consider:

1. The impact of the Retailer Reliability Obligation (RRO) on wholesale contracting timing and costs in Victoria, and
2. The disproportionate impact of the VDO on 2nd and 3rd tier retailers

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



Impact of RRO on Victorian wholesale contracting costs

The ESC clearly describes the terms of reference under which the VDO has been developed, and the interpretation of its statutory objective in developing the VDO. It is understood the ESC has employed the use of a futures market approach to wholesale electricity cost estimation and has used quarterly future contract prices from 1 July 2019 to 30 June 2020 to determine future prices.

The calculation of efficient contracting options for a given level of risk, and the estimation of retailers' hedging products in the development of a VDO price, is based on unclear underpinning assumptions of retailer contracting behavior to achieve a minimal risk position.

The regulatory environment has the potential to impact retailer contracting behavior to differing degrees. The Retailer Reliability Obligation (RRO) is timetabled for implementation on 1 July 2019 and any triggering of the obligation may have a material impact on hedging strategies by retailers to ensure compliance. It may also have varying impacts to a retailer's wholesale electricity costs depending on its customer mix and ability to access contracts. It is unclear whether the ESC has considered the RRO in its assessment of wholesale risk and provision of allowance for retailers to manage efficient hedging strategies.

It is noted that the ESC states that previous submissions to this process did not provide robust data sources that specifically estimated costs driven by the change in the regulatory environment. Notwithstanding, we are concerned with the ESC's expectations that assume retailer operating costs will decline, taking into consideration the regulatory reforms currently underway in Victoria.

ERM Power believes that a potential exclusion of the RRO within estimated retail costs has the potential to underestimate the costs within the retail operating cost category. With a commencement of the RRO in July 2019, and if the circumstances of a forecast reliability gap exist in Victoria, AEMO could seek to trigger RRO obligation on retailers as early as the next day following publication of the Electricity Statement of Opportunities (ESOO) in August 2019. Any triggering of the RRO in Victoria may impact wholesale contracting costs, as retailers will be required to contract for a T-3 or T-1 gap period. ERM Power suggests that the impact of an RRO trigger on Victorian wholesale contracts be considered within the setting of the VDO and any subsequent revisions.

Effect on 2nd and 3rd tier retailers

The ESC presents data which demonstrates that there is a significant difference in retail operating costs between tier 1 retailers, and state and other commercial retailers. The modelling assumption is to use five years load and wholesale price data from 1 July 2012 to 30 June 2017 to provide forecast load and price values for 2019-20. Although the economies of scale which benefit tier 1 retailers has not presented a barrier to entry for smaller players, ERM Power is concerned that applying a VDO based on this dataset, in conjunction with any RRO reliability gap trigger, will impose costs on smaller retailers which cannot be easily absorbed. Additionally, the volatility of the Small-Scale Technology Percentage (STP), and historical discrepancy between estimated STPs and final published STPs exposes retailers to increased uncertainty and increased risk premiums. ERM Power cautions understating the costs stemming from the implementation of new regulatory reforms and the impact on 2nd and 3rd tier retailers, which may present a disproportionate impact to smaller market players.

Thank you for the opportunity to provide comment on this process. Please contact me if you would like to discuss this submission further.

Yours sincerely,



Emma White
Policy Adviser

