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Essential Services Commission
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Dear Essential Services Commission

Victorian Default Offer to apply from 1 January 2020 Draft Decision

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 Victorian Default Offer (VDO)to apply from 1 January 2020 Draft decision (the Draft Decision).

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 low 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 working alongside our customers to fund a large range of community and social enterprise energy projects through our Your Community Energy program.

General feedback

Consistent with our previous submission to the ESC's Issues Paper, Powershop does not support the proposed Victorian Default Offer (VDO) due to adverse impacts on all Victorian customers in terms of price, access to competitive and innovative offers, and reliability. We have already seen a reduction in innovative products and discounted offers, and with a convergence to the VDO based on offers available prior to 1 July and post 1 July, the VDO is effectively reducing the competitive innovations and incentives most engaged customers enjoy. This was never the intention of the VDO and it does not achieve compliance with the Order.

In addition, Powershop is disappointed that the ESC has not taken into consideration material feedback and recommendations from various industry submissions and forums, in relation to both the methodology and the calculation of the various cost inputs that make up the VDO. Our concerns are noted below.

We believe that without a strong, fair and transparent methodology applied to the calculation of a maximum annual bill amount for non-flat standing offer, there will be further significant unintended consequences that will impact customers and industry. We do not believe the Draft Decision achieves such transparency or a robust calculation methodology that reflects an efficiently operating retailer. We note in further detail below, issues that the ESC needs to address before 1 January 2020.

Most importantly, the Draft Decision does not achieve the objective of the VDO "to provide a simple, trusted and reasonably priced electricity option that safeguards consumers".[1]

Wholesale Costs

Powershop notes that the ESC has not changed its underlying methodology set out in the Issues Paper to the Draft Decision to calculate the wholesale electricity cost (WEC) component of the cost stack. We are concerned that the ESC is not applying a pragmatic, balanced approach to calculating wholesale costs, specifically the Draft Decision ignores recent market volatility with the expectation retailers will incur and absorb higher actual costs and risks.

The STRIKE 'black box' optimisation model is a theoretical simulation methodology used by Frontier Economics and applies a median cost from a range of possible outcomes. Using this model as the basis for the calculation of the WEC is not appropriate when there is an opportunity to forecast on at least an average expected value outcome. Ultimately, retailers should be compensated for the expected wholesale cost they incur, which is reflective of true volatility from the market and not a median based on random, simulations that are not sufficiently aligned to reality and bare no accountability. We believe this concept constitutes part of a "reasonably priced electricity option".[2]

Powershop acknowledges and agrees that for the estimation of consumption load data, the ESC will incorporate the most recent data available in its analysis of consumption load data. Using this data should reflect the changing and increasing risk of hedging costs due to the higher ratio of peak to average load and a higher load variance.

However, we do not support the inconsistent use of consumption load data from 2 years for the calculation of the 1 July VDO and the use of the previous three years consumption load data for the Draft Decision. The above change significantly dilutes and flattens the true costs retailers have incurred for 2017/18 and 2018/19, when compared to the less volatile, pre-Hazelwood closure, 2016/17 period. Naturally, data that is more recent provides a better indication of the range of future outcomes and should have more weighting placed upon it in any determination of expected wholesale costs. This helps to better keep pace with the rate of change and transition in the market and will allow customers to experience the benefit of a more renewables orientated and integrated system more immediately. The older half-hourly data prescribes customers on the VDO to market conditions consistent with an obsolete system.

The Draft Decision raises further questions on the integrity of the dataset decision in light of 2016-17 having flatter consumption loads when compared to the more recent 2 years which have experienced more volatility and higher costs associated with hedging customers. To ensure industry can rely on a predictable calculation of these datasets for future calculations, the ESC must adopt a consistent window weighted to recent periods in the Draft Decision. This would remove any doubt as to the intent of the calculation being skewed to a subjective position and retain confidence and trust in the methodology.

Retailers should also be compensated for the rise in wholesale costs, particularly when the VDO potentially encourages increased consumption demand from consumers transferring from market offers (particularly 12-month fixed price contracts) to the VDO price that they assume is a government-endorsed "cheap" and fair price. Despite efficient, disciplined hedging practices retailers will still incur losses for transferring customers from hedged market positions to prescribed VDO hedge positions because of this regulatory intervention. The Draft Decision does not acknowledge that retailers will hold greater amounts of capital which will increase financing and hedging costs, borne by consumers who (despite their proactive market engagement) enjoy the benefits of market rates below the proposed VDO.

[1] Victorian Government Gazette, 30 May 2019, Page 1

[2] Victorian Government Gazette, 30 May 2019, Page 1

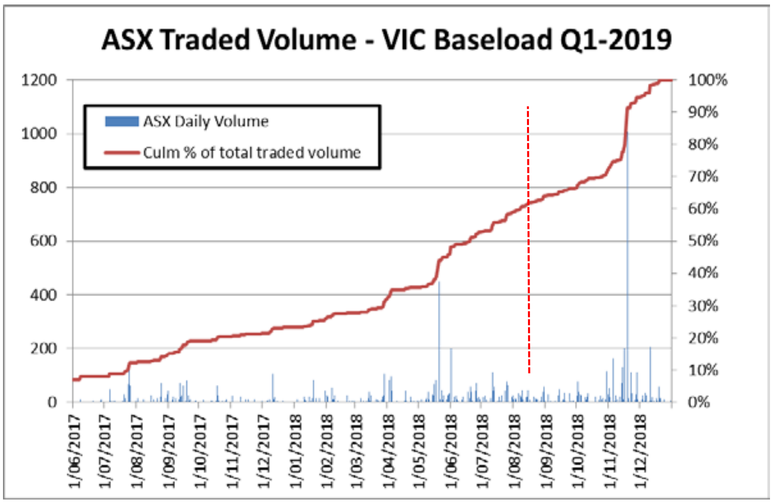
Powershop believes that the ESC has still not addressed the definition of peak demand in the 1 January 2020 VDO. The Frontier Economics material that the ESC has published fails to provide this definition. Powershop again reiterates that "the ESC should be cognisant of the fact that many retailers are required to be risk-averse and cannot reasonably be expected to incur excessive costs associated with not hedging to at least historical peak demands". Whilst the Frontier approach moves away from hedging these extremes due to assumed low pay offs, retailers may not be in a position, or have the working capital, to adequately handle large swings in cash flow and as such chose to hedge extremes to a higher degree.

The WEC is derived from a 12-month trade-weighted average price in the lead up to the pricing period. This forces retailers to hedge for an expected customer number which may be almost two years in the future. Additionally, it is only with perfect foresight that a retailer could align hedges to the trade-weighted volume as it is not possible to predict the volume of trades in the remainder of the 12-month window.

Powershop suggests the final date to be applied to calculate the '12-month trade-weighted average price' is calculated after the ASX option expiry on 19 November, to allow for the use of option contracts for hedging and to include current market views on price. Retailers use ASX listed options contracts to manage retail price risk as an effective way to hedge price uncertainty and load forecast risk due to uncertain customer numbers and load. ASX financial year and calendar year options are standard hedging tools used by the entire market.

The proposed methodology of using the 12-month trade-weighted average up to 16 August 2019 excludes the 2020 calendar year option expiry and a large portion of total contract volume traded between September to December, subsequently the financial year option expiry is over-represented (occurs in May and falls in the current lookback period).

Powershop believes that the methodology must include the most recent prices, as they best indicate the market view of spot prices in the coming year. Selecting a much earlier calculation date will not represent the expected spot outcomes for a customer or how retailers book-build coming into a calendar year. The graph below shows the Q1-2019 contract which we believe is a reasonable representation of how traded volumes of contracts build up over time. Using a date in August (see red dash line) will exclude approximately 40-50% of the total contracts traded prior to the year commencing.



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 magnitude of deviations against the predicted costs. Powershop believes that the method applied by Frontier Economics needs to be tested against the disaggregated, real data to ensure that the wholesale costs calculated are reflective of the costs retailers incur and should be compensated for accordingly. To apply a wholesale cost amount that does not reflect true costs is misleading and will ultimately drive increased costs for non-VDO customers.

Overall the WEC methodology is very conservative, with each individual decision adding to an overall reduced risk profile for which an efficient retailer would allow a risk premium under normal prudent hedging practises. In addition, to this risk premium, retailers must take a view on their changing customer-base, which is impacted by forecast assumptions on sales, churn, customer load and customer mix. The current VDO methodology does not allow for this significant volume forecast risk faced by most retailers and is heavily biased towards larger retailers with stable customer-bases.

As advised above, the methodology should reflect actual expected costs (not a generated simulation) and allow for the changing risk of increased hedging costs in order to address the upcoming tight supply acknowledged by the Draft Decision. However, the Draft Decision is incorrect to apply a 3-year window to measure current volatility. Powershop agrees that it would be short sighted to apply only the last financial year as a volatility measure which is why we recommend applying the last 2 years of data weighted to recent periods to measure volatility.

LRET

Powershop agrees with the Draft Decision's market-based approach in relation to the Large-scale Energy Renewable Target (LRET) scheme, particularly as not all retailers have the credit or other capability to execute power purchase agreements. Powershop notes that the ESC proposes to use a cost pass-through to account for any over/under-estimations of the input variables by the ESC. We note that while this seems reasonable, all retailers will have to wear the ESC's forecasting estimation risk and will incur real costs of getting these wrong. The ESC should allow for this cost within the calculation.

Network losses and costs

When determining the 1 January 2020 VDO, the ESC must take into consideration that the network loss factors will change during that VDO period.

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 bear the risk of a greater proportion of network costs and cross-subsidising VDO customers because the Draft Decision applies an inefficient methodology.

Retailer Reliability Obligation (RRO)

Powershop does not agree with the Draft Decision regarding the Retailer Reliability Obligation (RRO) – "As the overall impact for the policy showed a net benefit, without further clarity on the specific costs that are incurred by Victorian retailers we do not propose to make an allowance for these costs. Nonetheless, we plan to continue collecting cost data and will review any changes over time".[3] This position ignores the requirement for retailers to be hedged to their one-in-two forecast peak demand one year in advance of a reliability gap period. We also previously advised that Frontier Economics has ignored current industry practice adopted by prudent, efficient retailers whereby they 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. The RRO commenced on 1 July 2019 so it now impacts a retailers' cost stack.

VDO compliant maximum annual bill (Maximum Bill)

Consistent with our submission on the Issues Paper, Powershop strongly suggests that the ESC should either delay the implementation of the maximum annual bill for non-flat standing offers or adopt a similar approach to that used by the Australian Energy Regulator in setting the Default Market Offer. As indicated by most retailers, we have concerns over the lack of regulatory obligation for a network distributor to reassign a customer to a flat network tariff based on a customer choosing the VDO.

Powershop also agreed with the concerns raised in relation to the impact on the market of applying a maximum bill being that it would reduce efficiency, distort price signals (peak and off-peak) and negatively impact customer demand.

A maximum bill should not eliminate the incentive for a customer to shift their demand to off peak periods and we are pleased the ESC recognises this issue. However, the ESC is incorrect to link customers unwillingness or inability to engage in the market to the validity of price signals. It is not the role of the ESC and the Order to decide if market mechanisms are effective.

The solution for the ESC is to apply the maximum bill only at a level that brings this customer group back to a price that is reasonable. The maximum bill must not impact or disincentivise the majority of customers who do benefit from and utilise price signalling when consuming at their relevant peak to off-peak periods.

[3] Essential Services Commission Victorian Default Offer to apply from 1 January 2020, Page 34

Forcing retailers to repeatedly overcharge and refund customers is a poor customer experience and will increase the number of bill adjustments across industry, eroding consumer confidence further due to poor regulatory policy. The Draft Decision outlines the maximum bill is required to achieve its objective, as stated above however the maximum bill will not provide a simple, trusted and reasonably priced option.

Retail Operating Margin

We advised in our submission paper to the VDO that the setting of a low Retail Operating Margin will impact the ability for customers to continue to access additional benefits, improved customer service, incentives and other innovations available in the market prior to 1 July 2019. The Draft Decision does not increase the incentive for retailers to improve or invest in customer service and product offering and choice, therefore stronger competition.

The 1 January 2020 VDO should only achieve the key outcome of providing a fair offer for disengaged customers on standing offers and not have any further unintended consequences as referred to above.

Customer Acquisition and Retention Costs (CARC)

Powershop does not support the Draft Decision adoption of a benchmarking approach and an inadequate CARC of $38. The Draft Decision still fails to follow the Fair Pricing in the Energy Market – Terms of Reference for the Essential Services Commission (ToR) and therefore the CARC is not a modest allowance.

Powershop agrees with the use of a benchmark approach if the benchmark applies relevant data. This is where the Draft Decision fails in its application. It is not appropriate to apply averages that are now 6 years old, from a jurisdiction far more expansive than Victoria, ignoring Victorian specific costs, at a time when that jurisdiction was a fully regulated industry. Such flawed data will not reflect the true current CARC Victorian retailers incur.

Powershop supported the formal information request from the ESC in September 2019 to support our basis of the CARC being calculated on current marketing standards and approaches, including additional costs incurred to allow for regulatory changes imposed by the VDO. We encourage the ESC to follow through with the review of this data to cross check against the inadequate $38 proposed and support the use of this data to help future price determinations.

Powershop does not support a CARC that unintentionally stifles the promotion of innovative products and offers, customer engagement in the market and the ability of customers to explore and exercise their rights to choose various offers and products that suit their needs. Powershop would like the ESC to use current evidence and costs that have been incurred in the Victorian market in order to establish a 'modest' CARC.

Powershop would like to understand why CARC and Retailer Operating Costs were not adjusted for inflation, in line with the adjustment made to the ESC licence fees.

As we noted in our submission to the Issues Paper, the ESC should monitor and report on the impact of the initial VDO, and other new regulations, to determine whether the VDO is working, fit for purpose and should in fact continue. The ESC should review the interplay with other Victorian Government policy initiatives, including the Solar Homes Package and the avoided social cost of carbon endorsed cross-subsidy.

Currently the Draft Decision drastically understates the true costs incurred by Powershop and, we believe, other retailers in offering the VDO. Consequently, in the time between the Draft Decision and the final decision it is critical for the ESC to correctly assess the VDO before the 25 November deadline, including the incorporation of the most up to date wholesale data and information. Powershop suggests adopting a more considered and measured approach than that adopted in the Draft Decision, with further consideration to be given to reducing the potential negative impacts on prices, competition, innovation and investment.

We encourage the ESC to avoid implementing a VDO that has clear adverse effects on Victorian consumers, the energy market and ultimately the Victorian economy.

If you have any queries or would like to discuss any aspect of this submission please do not hesitate to contact me.

Yours sincerely,

Michael Benveniste
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Meridian Energy Australia