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17 October 2019

Ms Kate Symons
Chairperson
Essential Services Commission
Level 37, 2 Lonsdale St
Melbourne VIC 3000

Submitted electronically

Dear Ms Symons,

Re: Draft Decision - Victorian Default Offer to apply from 1 January 2020

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to comment on the Essential Services Commission (the Commission)'s draft decision on the Victorian Default Offer (VDO) to apply from 1 January 2020.

Red and Lumo strongly support deregulated and competitive retail markets, and note that the introduction of the VDO is counter to our position. We consider that price regulation distorts the market and disincentivises retailers delivering consumer benefits, such as more innovative products and services. Despite our position, we provide our commentary on the draft decision with a view to minimise any unintended consequences on Victorian consumers and to allow for competition to continue, albeit in a constrained environment.

Framework and methodology

Retaining the methodology used to calculate the first VDO provides consistency and reassurance to industry that it will be able to recover costs in future years. Apart from some specific issues about the draft decision that we discuss in more detail below, our most significant concerns about the VDO relate to the overarching framework and elements of the Order in Council (the order) undermines effective competition, ultimately to the detriment of Victorian consumers. Particular examples of this are the instructions to the Commission to exclude headroom, to only allow a modest allowance for customer acquisition and retention costs (CARC), and a provision stating that the Commission does not need to ensure that the expected benefits of its determinations exceed the expected costs. While we understand that the Commission is acting under instruction, as prescribed in the order, it is prudent that the Commission acts conservatively, in accordance with its objective as prescribed in section 8A of the *Essential Services Commission Act*, when determining the VDO.

The Commission is also instructed in the order, to base the VDO on the 'efficient costs of the sale of electricity by a retailer'. This cannot be known with certainty, either at a point in time or into the future, so the potential for the Commission to set the VDO at too high or too low a level, or for the final decision to disadvantage some retailers relative to others, is high. Therefore, we continue to recommend that the Commission adopt a conservative approach to the estimation of individual cost components.

Timing of final determination

The Commission is aware of the potential for individual items to change substantially prior to final decision, stating:

Our draft decision does not include figures for VDO tariffs and the compliant maximum annual bill. We have taken this approach as many of the variables impacting the VDO such as wholesale electricity costs, and network costs, are based on market data or tariffs approved by other regulators that are likely to change between the draft and final decisions.¹

There are three components that are likely to result in a change to the final published VDO - network, wholesale and environmental schemes. These cost inputs are not insignificant and each of these are discussed below.

In order to avoid further impacts to consumers through the incorrect setting of the VDO, the Commission must focus on getting the estimation of individual cost components right. An increase in an individual component, such as the expected increase in network costs, should not have a flow on impact to other elements of the cost stack.

Having announced an expected price rise percentage in its draft decision (of 1.3% and 1.7% for residential and small business customers respectively), it would be disappointing if the Commission set out to achieve a similar percentage increase in its final decision without taking into account changes in the individual components. Should the Commission, for example, determine that previously announced network cost allowance was underestimated we assume that this would lead to a higher VDO than the previously announced increase, rather than a reduction in the allowance in other cost components to compensate for the higher network allowance.

We also note that the Commission must consider the financial viability of the industry under section 8A(b) of the *Essential Services Commission Act*, and the incentives for long term investment under section 8A(a) of the *Essential Services Commission Act*. In our view, failing to calculate the individual cost components independently from each other would substantially erode industry's confidence in the Commission's methodology and its belief that it can recover reasonable costs going forward. Not only would this undermine the sustainability of retail operations and the financial viability of specific retailers, it would also discourage further long term investment, all of which are to the detriment of Victorian consumers and contrary to the Commission's legislative objectives.

Network costs

The order mandates that the Commission must make its final decision and determination by 25 November. This provides a very tight window of opportunity for the Commission to account for the Australian Energy Regulator's final decision for 2020. Post the release of the Commission's draft decision on 20 September, electricity networks published their proposed network costs with an increase of between 4.5% to 9.2% across the five networks which will lead to a higher VDO than the draft decision (which assumed an increase in network costs of around 4% as a pass through).

¹ Essential Services Commission (2019), *Victorian Default Offer to apply from 1 January 2020: Draft decision*, page 12

As stated above, Red and Lumo urge the Commission to review each component of the VDO cost stack individually, to reflect as much as possible, the actual costs borne by retailers. Given that the Australian Energy Regulator will set the final electricity network annual tariffs by around 13 November, we expect that this is taken into account by the Commission in their final decision.

Wholesale costs

We appreciate the Commission and Frontier Economics' efforts to provide as much clarity as possible on their calculation of wholesale costs through the publication of Frontier's supporting spreadsheets.

We also acknowledge the futures market approach is consistent, and similar to that used by regulators in other regulatory determinations. Frontier's approach is reasonable but we reiterate that these calculations produce a single estimate that is one of many feasible outcomes for an efficient retailer and should be viewed as such. The estimate may reflect the actual costs that some retailers incur (such as those with a large and varied consumer base) but not others and could unfairly disadvantage specific retailers. Furthermore, it could act as a barrier to entry for prospective retailers if the wholesale allowance is set too low or does not account for volatility.

We welcome the Commission's commitment to update its estimate of wholesale costs with the latest available pricing data, while recognising the requirement to make a final determination no later than 25 November. The Commission acknowledges that a 12 month average better reflects retailers' actual hedging strategies, while contract prices closer to the start of the contract period capture more (and better) information about underlying supply and demand conditions.

We have observed, for example, that prices for VIC Q1 20 Caps have recently increased in value (considerably) due to reliability concerns. There have also been delays in renewable projects scheduled for commissioning in mid to late 2020 that may not be fully factored into the contracts process yet, or at least not in the year prior to August. Furthermore, in October 2018, the Cal 20 Vic flat contract was trading at approximately \$77/MWh but it is now over \$100/MWh. Frontier should be capturing this information in the calculation of its 12 month average.

We also note the discussion at the recent public forum on Frontier's decision to use Manually Read Interval Meter (MRIM) data for a 3 year period to calculate the load profile of a representative year, rather than 2 years (which it used for the previous VDO). We note the Commission's statement that *'it is our view that utilising three years of data to generate a simulated year (rather than just the most recent year) results in a forecast that is less exposed to the events of a specific year. This also provides methodological stability.'*²

There is some merit to this but in our view, the Victorian market has fundamentally changed since 2017, with the closure of Hazelwood in March 2017 and the continued penetration of solar PV. The Hazelwood closure in particular represents a substantial shift in the dynamics of the Victorian wholesale market and we are observing greater volatility in pricing as a result.

² Ibid, page 21

This has prompted the Victorian Government to request a rule change for a jurisdictional derogation to give the Australian Energy Market Operator the option to negotiate longer RERT contracts.³

Whilst we support the use of a 3 year data set to determine wholesale allowances, we do not support the use of this methodology for this determination. Due to the closure of Hazelwood it is our view that including MRIM data from 2016/17 would not provide an accurate representation of the current Victorian wholesale market and should be excluded from Frontier's calculations. The Hazelwood closure was a step change in the wholesale market, and therefore market data prior to that time should not be included in the actual data sets. On that basis, we support a 2 year data set for the wholesale his calculation for this determination.

This is another area where the use of more recent and appropriate information will result in the final VDO that differs from the draft VDO and the rationale for this must be made clear to all stakeholders.

Environmental and other regulatory costs

We have concerns about the Commission's decision to use the non-binding estimate of the Small Scale Technology Percentage (STP) for 2020 of 14.56%. The Commission states that this is the best publicly available information and that it will use a cost pass-through in the following year to account for any difference.

We support the inclusion of a pass through mechanism in subsequent regulatory periods and it is vital that all stakeholders, including the Victorian Government, understand and accept the rationale for and importance of this adjustment.

However, the pass through clearly distorts current and future VDOs and the Commission should look to minimise this distortion as much as possible. In the case of SRES costs, we recommend the Commission liaise with the Clean Energy Regulator (CER) as it reaches its final decision to identify a more up to date, and more accurate, estimate of retailers' likely liability.

In the past 2 years, the non-binding estimate that the CER has made available at this time of the year has fallen substantially short of the final liability, announced in March the following year. For example, the final STP for 2019 was 21.73% compared with the published non-binding estimate in the previous year of 12.13%; and the final STP for 2018 was 17.08% compared with a published non-binding estimate of 8.06%.

The CER explains clearly on its website how any surplus STC creation in one year above the target is carried forward for surrender the following year and therefore uplift the % STP. We note that by early October STC creation in 2019 has reached 28.3 million against the CER's estimate of 29.6 million for the full year.⁴ Based on the current run rate of STC creation, 37.8 million will have been created by the end of December, resulting in a surplus of 8.2 million STCs to be surrendered in 2020 above the CER's target of 20.8 million.

³ See <https://www.aemc.gov.au/rule-changes/victorian-jurisdictional-derogation-rert-contracting>

⁴ See <http://www.cleanenergyregulator.gov.au/RET/Scheme-participants-and-industry/the-small-scale-technology-percentage>

By prorating the CER's STP estimate by the uplift in total surrender volume of 29.0 million in 2020, an uplift in the CER's non-binding estimate of 14.56% to 20.3% is expected. Noting that our STP forecast is based on the actual recorded STC creation today, so it provides the basis of a much better prediction of annual STC creation than that published by the CER in March 2019 and can be simply validated and adopted by the ESC when setting the final VDO.

Retail costs

Customer acquisition and retention costs

Red and Lumo still hold concerns about the Commission's estimation of CARC. We recognise that the Commission is explicitly instructed to only include a modest allowance and this is the main driver behind the relatively low amount in VDO 1 and now in the draft decision for VDO 2.

However, we continue to challenge the Commission's view that CARC offers no benefits for many Victorian consumers, particularly those who aren't currently engaged in the market by entering into a market retail contract. As the Commission is aware, there has been a steady decrease in the number of consumers on standing offers in Victoria and this is due to retailers' marketing activities within a highly competitive environment. The Commission cites analysis by the Australian Energy Market Commission of switching rates and suggests they have remained constant, while CARC expenditure in Victoria has increased. However, these switching rates do not capture situations where a consumer changes plans with their current retailer.

Consumers who are currently on a standing offer know they can switch retailers if they are dissatisfied with their current provider because of the messages they receive through the market. Alternatively, they can change to a more competitive market offer while remaining with their current retailer at any time, even if they choose not to or have not chosen to do so recently. They are in no way prevented from switching, and as the Commission is aware, numerous recent regulatory initiatives - such as the inclusion of best offer calculations on bills and the VDO as a reference price - are specifically designed to encourage market participation.

Therefore, it is reasonable for the Commission to reassess its interpretation of what a 'modest allowance' for CARC should be, and increase it to a level that is better aligned with retailers' actual CARC.

Retail operating costs

The Commission explained in its advice for the first VDO that it was not including a specific allowance for regulatory costs but instead, was relying on benchmarks from other contexts. Now that the Commission has received information from retailers in response to a data request, it will be better placed to quantify the incremental impact of specific regulatory initiatives. In the draft decision there are no inclusions for any specific provision for the cost of the 1 July 2019 measures - such as clear advice entitlement and inclusion of best offer calculations on bills - but these costs would not have been captured in those benchmarks as they are *Victorian specific* changes. It is now reasonable for the Commission to include these costs.

The Commission will also be aware that retailers are starting to incur costs as part of the move towards 5 minute settlement of the wholesale market. This is a major initiative that will impose costs on retailers as they update their systems (including settlement; risk management; trading; billing; reporting; data collection and storage) and processes to reflect the five minute settlement intervals, and to renegotiate any longer term hedging contracts. Retailers will continue to incur these costs in the lead up to commencement on 1 July 2021.

Following the completion of the procedures package and the impending completion of the file format design, retailers are now better placed to provide the Commission with more rigorous estimates of the cost of implementing 5 minute settlement. These would not have been available when the Commission made its final determination for the first VDO. Red and Lumo can provide the Commission with estimates of the timing and magnitude of these costs.

As a final point about retail operating costs and CARC, it does not appear that the Commission has adjusted these amount for CPI, despite inferring it.⁵ This should be rectified in the final decision.

Maximum allowable annual bill

Despite some practical challenges for retailers around the gazettal process, we support the Commission's preferred model for the maximum allowable annual bill for VDO 2, namely, to prescribe the maximum amount a consumer will pay for a single level of consumption. The Commission's analysis of the two options is reasonable and we agree with its preferred approach to allow retailers to set their own rates to try to manage their exposure to network costs.

It will be challenging for retailers to develop and then gazette their rates for flexible standing offer contracts within the prescribed timeframe (25 November to 18 December) given the lateness in the calendar year and that all retailers will be seeking to publish their rates around the same time. We would welcome the Commission having discussions with the gazettal office to ensure that retailers can submit their documentation in a condensed timeframe, instead of conforming to their two weeks in advance convention.

We also require more detail about the Commission's process for assessing and approving retailers' proposed usage profiles for non-flat standing offer tariffs other than those listed in Table 12 in the draft decision and schedule 3 of the order.⁶

While we recognise it is not possible for the 2020 VDO, Red and Lumo's preferred position remains that the distribution networks should reassign any customer who selects the VDO to a flat network tariff. This is consistent with the broad objective of the VDO, which is 'to provide a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market'.

⁵ Essential Services Commission (2019), op. cit., page 43

⁶ Ibid, page 68

This removes retailers' exposure to underlying network costs when their customers use energy at peak times, particularly when they are limited in how they can manage that exposure through retail prices. It is clear that retailers are potentially exposed to network costs that they cannot pass through for some consumers at the prescribed level of consumption.

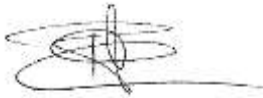
However, the Commission notes that the extent of this is likely to be low given the relatively small number of standing offer consumers on flexible tariffs. However, this could become a more substantial issue over time, depending on the networks' tariffs and assignment policies, as any consumer can opt for the VDO and those with peakier consumption profiles will have a strong incentive to minimise their exposure to higher costs during peak times.

About Red and Lumo

Red and Lumo are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, South Australia, New South Wales and Queensland, and electricity in the ACT to over 1 million customers.

Should the Commission wish to discuss or have any enquiries regarding this submission, please contact Geoff Hargreaves, Regulatory Manager on 0438 671 750.

Yours sincerely

A handwritten signature in black ink, appearing to be "Ramy Soussou", written over a faint, circular scribble.

Ramy Soussou

General Manager Regulatory Affairs & Stakeholder Relations

Red Energy Pty Ltd

Lumo Energy (Australia) Pty Ltd