

17 October 2019

Essential Services Commission  
Level 37, 2 Lonsdale Street  
Melbourne VIC 3000

Via [engage.vic.gov.au](http://engage.vic.gov.au)

**Re: Victorian Default Offer to apply from 1 January 2020 – Draft decision**

Simply Energy welcomes the opportunity to provide feedback on the Victorian Default Offer (VDO) to apply from 1 January 2020 draft decision.

Simply Energy is a leading energy retailer with over 720,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. As a leading retailer focused on continual growth and development, Simply Energy supports the development of effective regulation to facilitate competition and positive consumer outcomes in the market.

Simply Energy thanks the Commission for engaging with industry on the development of the updated VDO. While Simply Energy understands the reasons behind the introduction of the VDO, it must be stated that Simply Energy does not support price regulation in competitive markets.

Simply Energy's submission addresses a number of components that make up the VDO cost stack and provides general feedback on the proposed approach for non-flat tariffs, following this structure:

1. Wholesale costs
  - 1.1. Suggested Improvements to the wholesale electricity cost calculation
  - 1.2. Case Study: Wholesale electricity cost: Powercor distribution region
2. Network costs
3. Retail operating costs
4. Customer acquisition and retention costs
5. Retail operating margin
6. VDO compliant maximum annual bill
7. Other regulatory costs
8. General comments on the VDO methodology

Simply Energy considers that if any of the cost stack elements are not adequately accounted for, or the forecasting methodology and associated inputs are not carefully considered, then electricity retail competition in Victoria could be severely diminished.

The outcomes of lessened competition on consumers are important to consider, as the intent behind the VDO is to protect consumers in the long term, while the possibility of negatively impacting those consumers willing to engage in the Victorian electricity market remains real. Needless to say, Simply Energy is committed to ensuring good consumer outcomes.

## 1. Approach to estimating wholesale costs

Simply Energy considers that correctly accounting for wholesale electricity costs (WEC) is a critical requirement for the VDO, and therefore for positive consumer outcomes from competition in the Victorian electricity market.

The significant impact that changes in WEC has on retailers is ultimately represented on a consumer's bill. Simply Energy's view is that the Commissions' approach, through Frontier Economics, has systematically underestimated the future wholesale costs for the 2020 calendar year as the forecasts fail to fully take account of changes in the market.

The increased volatility and extreme pricing outcomes observed earlier in 2019 do not appear to have been successfully represented in the final wholesale electricity cost (WEC) forecast. Simply Energy recommends that all of the available ASX data (base swap, peak swap, cap) is considered in the modelling. The inclusion of the base swap only, to the exclusion of the peak swap and cap is effectively cherry-picking data and this is a critical flaw in Frontier Economics' modelling that impacts heavily on the Q1 2020 forecast.

Simply Energy recommends that the Commission updates the methodology behind the WEC calculation when determining the final VDO to apply from January 2020, in line with the approach and case study set out below.

Given the extreme pricing outcomes observed over Q1-2019, and the associated hedging risks being heavily skewed towards this volatile period relative to the rest of the year, the analysis below is restricted to this particular quarter. Adjusted WEC for Q1 2020 and Calendar year 2020 (the remainder of the quarters are unchanged) is provided below with a comparison between the Frontier Economics forecasted WEC and Simply Energy's forecasted WEC using the more accurate methodology that omits none of the relevant and available ASX data.

	Cal 2020	AusNet	CitiPower	Jemena	PowerCor	United
\$/MWh	Frontier WEC	108.70	106.13	111.15	107.57	111.30
	Simply Energy WEC	116.07	111.60	119.53	114.28	119.69

	Q1 2020	AusNet	CitiPower	Jemena	PowerCor	United
\$/MWh	Frontier WEC	191.19	183.17	201.82	190.96	201.00
	Simply Energy WEC	225.82	210.37	242.30	223.61	240.71

Simply Energy acknowledges that Frontier Economics has incorporated some of the previously-suggested changes resulting from Simply Energy's submission early in 2019, particularly separating the modelling into residential and business consumers and utilising the most current MRIM data.

Nevertheless, Simply Energy highlights four key issues that remain in the Frontier Economics methodology and associated inputs:

- (i) **The methodology used to scale the historic spot price does not consider a number of important factors.**

The flawed methodology used to scale the historical spot price to the current ASX forward price has not changed since the first VDO determination. This is addressed in more detail in section 1.1 of this submission.

- (ii) **Data from FY16-17 is used in the calculation methodology.**

This period being largely before the closure of Hazelwood power station. The closure of Hazelwood resulted in a dramatic shift in the market, regarding both the shape and level of price. Simply Energy recommends that only the data post-Hazelwood closure be used as a basis for the shape and level of the 2020 wholesale electricity market.

- (iii) **The half hourly spot price trace used in the modelling appears to reach levels of around \$17,000/MWh.**

Simply Energy understands that the current market price cap is \$14,500/MWh and increases only by CPI each year (going to \$14,700/MWh in 2019-2020), which is below the level the trace appears to reach.

- (iv) **The ASX Energy Contract prices are current to 16 August 2019.**

Simply Energy understands that the VDO draft decision takes into ASX contract prices up to 16 August 2019, due to the availability of pricing at the time the draft decision was made. Simply Energy expect that when the final advice for VDO is prepared, more recent ASX contract prices will be utilised to reflect any movements in the wholesale forward market, allowing for a more accurate WEC calculation.

### **1.1 Suggested improvements to WEC calculation methodology**

The methodology employed by Frontier Economics scales the spot price appropriately to ensure the flat swap aligns with the ASX forward price. This methodology, however; fails to account for the value of caps and the implied volatility. Frontier Economics raises concerns regarding the scaling of spot price traces to peak and cap pricing outcomes in addition to base swaps. Frontier Economics states that “an alternative approach would be to attempt to scale half-hourly prices having regard to each of base swaps, peak swaps and cap prices. However, the scaling process would require subjective judgements about how to simultaneously scale to each of these prices.”<sup>1</sup>

Simply Energy considers that the requirement to apply judgment is an insufficient reason to ignore relevant data (which is required to provide an accurate forecast) when a reasonable basis for judgment exists. Simply Energy provides an approach below, which has a reasonable basis in following a logical or preferred methodology that alters the original spot price trace as little as possible.

This approach reduces the adjustments to Frontier Economics’ original price trace in the analysis below, such that scaling factors for spot prices are kept as close to 1 (one) as possible, while making use of all relevant ASX prices (base, peak and cap).

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<sup>1</sup> Frontier Economics, ‘Wholesale Electricity Costs for 2020 – A report for the Essential Services Commission’ (16 September 2019) pg16

## 1.2 Case Study: Powercor Wholesale Electricity Cost Example

The table below shows the base and peak swap values for Q1 implied by Frontier Economics' spot price trace, in addition to the cap value for the same corresponding period. Simply Energy has extracted the same ASX data over the same 40-day period as stated by Frontier Economics (noting that the data is not shown in Frontier's report), which shows significantly higher trading levels for the Q1 quarter over the peak and cap contracts. For the purposes of this analysis, Simply Energy has retained Frontier Economics' base swap value in the scaled spot price trace, but also used the calculated 40-day average peak and cap value to scale.

Q1 2020	\$/MWh		
	Base Swap	Peak Swap	Cap
Frontier Economics (5% premium excluded)	139.78	189.32	24.74
Simply Energy	147.42	214.43	46.71

The lower value inherently attributed to the peak and cap contracts in Frontier Economics' original spot trace indicates a significantly flatter price profile over Q1. Given the correlation between load and pricing outcomes, this assumption has significant implications on the final calculated WEC. Higher peak outcomes would be expected to correspond with higher demands, driving up the pool bill for market participants. Frontier Economics' current spot price trace seems to diminish these risks for retailers.

The below outlines the exact steps performed to determine Simply Energy's proposed WEC for the Powercor distribution network.

Simply Energy has used the spreadsheets provided by Frontier Economics to re-calculate the quoted WEC in order to take into account the impact of the adjusted spot price scaling methodology as described in section 1.1 of this submission

Simply Energy does not have access to Frontier Economics' Monte Carlo simulation model, so instead we used the spreadsheet model (Appendix 1) and the single traces of data provided in that model.

Simply Energy have created a version of this Microsoft Excel file, which is provided to the Commission along with this response (Appendix 1). Note: In this file, any cells with blue coloured font represent Simply Energy calculations.

Frontier Economics' calculations assume that arbitrage exists in the market where the contract price is not equal to the price each quarter outturns at (time-weighted average of all spot prices). Simply Energy considers that this approach is not a fair representation of how contract traders generally forecast. While it is difficult to assess the impact in dollar terms of the difference in arbitrage assumptions, Simply Energy's view is that contract traders generally consider the use of the forward curve to provide the most accurate forecast and is useful in verifying that contracts are valued fairly.

Therefore, Simply Energy took the half hourly spot price trace from the Frontier Economics spreadsheet used to calculate the AEMO payment and rescaled it such that the base swap, in addition to the peak swap and cap values are aligned with Simply Energy's recalculated 40-day contract average derived from ASX data. These scaling factors can be seen in cells E17-G18 of Appendix 1

Scaling was performed quarterly using separate scaling factors for peak swap / offpeak swap and base cap, which were goal-seeked using Microsoft Excel's built in solver function, to minimise the sum of squares of errors.

Simply Energy did not change the levels of contract cover, as it does not have access to Frontier Economics proprietary model (STRIKE). It is noted, however; that with increased volatility, it is recommended that STRIKE be re-run to calculate new levels of contracting. It is also assumed no arbitrage between contract strike prices and outturn, therefore contract prices were assumed to be the same as the half hourly simulated price outturns.

## **2. Approach to estimating network costs**

Simply Energy agrees with the Commission that the general cost pass-through approach to network costs is the most prudent approach to reasonably allowing for network costs in the final VDO determination. Simply Energy understands that the Australian Energy Regulator is scheduled to approve network price determinations in mid-November.

Given that a significant portion of an electricity retail customer's bill is made up of network costs, it is imperative that the latest data be used when determining the VDO to apply from January 2020. The Victorian Default Offer 2020: Draft decision - public forum which Simply Energy attended on 8 October 2019 included the Commission providing assurance that the VDO would be recalculated with this new information.

## **3. Approach to estimating retail operating costs**

Simply Energy understands that in the Commission's final advice to Government for the VDO to apply from 1 July 2019, ICRC's regulatory benchmark was used, with an additional \$10 per customer as a recognition of the impacts of the payment difficulty framework and the analysis of Victorian specific costs in the ACCC's inquiry final report. Simply Energy considers that the recent raft of regulatory changes, including the clear advice entitlement, deemed best offer information on bills and bill change alerts have not been accounted for in the previous VDO determination and that the Commission should make allowance for these costs, as was done in the Commission's initial final advice for the payment difficulty framework. Simply Energy also understands the Commission has stated that it will provide an allowance for inflation regarding retail operating costs in the final determination and looks forward to the final retail operating cost component of the VDO cost stack including this allowance.

## **4. Approach to estimating customer acquisition and retention costs (CARC)**

While Simply Energy understands the Commission's position in regard to setting CARC, Simply Energy has seen a marked increase in these costs after 1 July 2019. While Simply Energy cannot speculate in a public submission on the possible reasons behind this increase, the simple fact is that the CARC provision in the cost stack does not represent the costs retailers face in Victoria. Simply Energy also understands the Commission has stated that in the final determination it will provide an allowance for inflation regarding CARC, which Simply Energy supports.

## **5. Approach to estimating retail operating margin**

Simply Energy understands that the Commission will use the recent formal data request to validate the assumptions and regulatory benchmarking used to estimate retail operating margin. Simply Energy considers this vital to ensure new entrants and retailers without generation assets are not unduly constrained.

Simply Energy is still of the view that the Victorian market is more evolved than other jurisdictions in Australia, involving unique challenges and high levels of competition. Price regulation in Victoria must reflect the costs that retailers in Victoria face. To use benchmarking and regulatory decisions from other jurisdictions creates unnecessary risk to retailers in Victoria and Simply Energy considers that a different approach is needed. While the Order in Council includes a provision that does not require the Commission to determine tariffs based on the actual retail operating margin of a retailer, it does not require the Commission to determine the VDO tariffs to the exclusion of actual retail operating margins.

## **6. Approach to the VDO compliant maximum annual bill**

Simply Energy's initial submission to the Commission's issues paper for the VDO to apply from 1 January 2020 urged the Commission to prescribe the rates for time-of-use. While Simply Energy still considers that this would be a preferable approach, we understand the rationale behind the elected approach and agree that this approach would result in a better outcome for the market generally than the second approach posed in the issues paper, where the Commission proposed a maximum annual bill for a range of consumption.

Simply Energy considers that the Commission's approach for tariffs and usage profiles that are not provided as a part of the 'Representative customer usage profiles' should not involve retailers submitting their estimations to the Commission. The already compressed time frame for the final VDO determination and gazettal of a retailer's VDO will result in unnecessary risk to retailers meeting the time frame. Furthermore, the fact that the Commission may not approve the retailer's calculation places further risk on retailers who choose to offer more cost reflective tariffs.

More importantly, the VDO is intended to be a "a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the electricity retail market."<sup>2</sup> Simply Energy considers that the outcomes this approach will elicit do not align with the intent of the VDO. The impacts of such an approach are that the VDO no longer becomes a consistent or fair price when likely outcomes are different prices among retailers, depending on the volume and load profile of each retailer's customer base on a combination of flat and non-flat tariffs.

As a result, Simply Energy recommends that if the Commission is unable to provide a standardised approach to setting these prices, these tariffs should be out of scope of the VDO until the Commission can undertake that required work. The VDO as a benchmark for a reference in advertising also becomes meaningless for consumers on these combination flat and non-flat tariffs when the reference price relates to a specific retailer's combination of flat and non-flat VDO as a benchmark. For consumers to use that reference to compare with other offerings from other retailers with similar tariff structures will result in confusion and potentially misleading outcomes.

## **7. Approach to estimating other regulatory costs**

While Simply Energy agrees with the Commission's approach to estimating other regulatory costs, Simply Energy considers that the allocation for licence fees from 2017-18 (with an allowance for inflation) of \$0.56 per customer no longer appears to be current. Simply Energy calculated the figure based on information outlined below to be \$0.86. This discrepancy highlights that the Commission needs to take new information into consideration for the final decision on the VDO to apply from 1 January 2020 VDO.

Simply Energy received notification of the Ministerial approved licence fees on 2 October 2019. While the notification was unclear on whether these licence fees include GST, Simply Energy has performed the simple calculation of dividing the Ministerial approved licence fee by Simply Energy's recently reported number of electricity and small business customers in Victoria as at June 30. This calculation yields a conservative figure of \$0.86 per customer or \$0.95 if the Ministerial approved licence fee does not include GST.

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<sup>2</sup> Essential Services Commission "<https://www.esc.vic.gov.au/electricity-and-gas/prices-tariffs-and-benchmarks/victorian-default-offer>" (16 October 2019)

## 8. General comments on VDO methodology

Simply Energy understands the initial policy position and that the VDO was intended to reflect the underlying costs of an efficient retail electricity business to provide consumers with a fair and reasonable price for electricity. Simply Energy recognises that the Commission issued a formal data request to retailers (including Simply Energy) to undertake a validation check on the assumptions made in the VDO. Simply Energy also understands that the Order in Council relating to the determination and application of the VDO does not require the Commission to determine and base tariffs on the actual costs, or actual margin of retailers.

Simply Energy still urges the Commission to undertake an analysis of the proposed costs of an efficient retailer against the actual costs incurred by retailers. Given much of the regulatory benchmarking used to determine margin and retail operating costs is taken from jurisdictions outside Victoria, it is imperative that the Commission understands the possibility of negatively impacting those retailers without generation assets, and new entrants into the market. The continued facilitation of healthy competition seen in the Victorian jurisdiction is of long-term value to consumers and should not be put at risk.

Simply Energy also recommends that the Commission undertake work to validate the underlying assumptions in the determination of the VDO. It is especially important that the assumptions and modelling behind the WEC is validated. Simply Energy has highlighted concerns in this submission and previous submissions regarding the methodology Frontier Economics has employed. This validation could extend to modelling and understanding the impact that the introduction of the VDO has had on offers in the market more broadly, including whether those consumers who choose to engage in the market have been impacted by price re-regulation. If those consumers have been impacted negatively, Simply Energy recommends that the Commission review its approach to price re-regulation in Victoria to ensure the VDO supports fair and reasonable prices for all consumers, not just those who are on standing offers for a variety of reasons.

### Concluding remarks

For the proposed 1 January 2020 VDO cost stack, the points made in this submission indicate that the Commission needs to take account of new information that has become available since the analysis for the draft decision was made, and also reconsider its conclusions on WEC.

In closing, Simply Energy looks forward to continuing to work actively with the Commission to ensure the inputs and methodology for setting the VDO accurately reflect the Victorian electricity retail market. We look forward to receiving confirmation of the VDO prices to apply from 1 January 2020.

Simply Energy welcomes further discussion in relation to this submission. To arrange a discussion or if you have any questions please contact James Ell, Senior Regulatory Adviser, on, telephone, (03) 9617 8352 or at [james.ell@simplyenergy.com.au](mailto:james.ell@simplyenergy.com.au)

Yours sincerely



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