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21 July 2020

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

Submitted electronically

Dear Ms Symons,

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

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make this submission to the Essential Services Commission's (the Commission's) consultation paper for the Victorian Default Offer (VDO) to apply from 1 January 2021. We support the Commission maintaining a consistent approach in its VDO determination, as it provides certainty for industry. However, there remains a number of items that must be reconsidered in the next determination.

We consider that the next VDO is set for a period of 6 months, and allow the Commission to account for changes to network and other regulatory costs in the 12 months from 1 July 2021. The next VDO must also reconsider retail operating costs and retail margins in light of the changing risk profile of retailers. This is in line with changes proposed by the Commission to the regulatory framework to assist customers in light of COVID-19, which has flow on effects on bad and doubtful debt provisioning in 2021.

In terms of ongoing matters, we consider that the Commission must continue to evaluate how best to account for environmental costs, particularly the Small-scale Renewable Energy Scheme where there is a misalignment between the Commission's determination and the Clean Energy Regulator's publication of retailers' liability under the Scheme. Recent changes to the advertising requirements relating to the maximum annual bill that the Commission sets for consumers on non-flat tariffs have caused confusion. We recommend that the Commission mandate that the distribution networks assign all customers selecting a VDO retail product onto a flat network tariff, rather than maintaining a potentially different underlying cost structure.

### **Retail operating costs**

The impact of COVID-19 has and will continue to result in many Victorian consumers struggling to cover expenses, including electricity bills. This will result in unforeseen changes to retail operating costs that were not accounted for in the last VDO determination. In assessing the change in retail operating costs, the Commission can refer to announcements by publicly listed retailers of their expected future provisions for bad and doubtful debts. As the data requested by the Commission relates to the period from 1 July 2018 through to 30 June 2019 (or the most recent auditable financial year records). This period will not account for COVID-19 related provisioning for bad and doubtful debts. As a result, we encourage the Commission to work with retailers rather than relying on retrospective data.

The broad impact of COVID-19 is unknown, and the Commission will need to continually check in with retailers to cross check against its previous operating cost benchmarks. These effects are evolving constantly and will continue to do so for the remainder of 2020, as government support is withdrawn and as other service providers, such as banks, return to their previous repayment and collection cycles. Therefore, Red and Lumo welcome the opportunity to maintain an ongoing confidential dialogue with the Commission regarding impacts of the pandemic on our operations, as it works towards its final VDO determination in November.

In addition to the impacts of COVID-19, the Commission will also need to account for the cost of new regulatory obligations that retailers will implement during 2021. Notably, the impact of the introduction of five minute settlement in the wholesale market, which will take effect from 1 October 2021, and changes to the allowable back billing period. This will require significant system and process changes, alongside additional data collection and retention. Red and Lumo would be happy to provide data and information to the Commission on a confidential basis.

### **Retail margins**

Red and Lumo encourage the Commission to reassess the allowable retailer margin to take account of numerous regulatory and other changes that have significantly altered retailers' risk profile, such as limitations on how frequently retailers can change their prices in response to cost movements. These also include measures that have been introduced at relatively short notice and in response to COVID-19 with limited consultation.

As part of providing support to small businesses that might be impacted by COVID-19, the Commission has proposed, as a temporary measure to extend the residential Payment Difficulties Framework to small business customers. This directly impacts the risk profile of retailers.

We recognise electricity is an essential service and policymakers and regulators are quick to respond to observed market outcomes and perceived problems through regulation. Many of these responses are reasonable but the volatility of the regulatory framework must be reflected in the allowable margin.

In our view, it is clear that electricity retail in Victoria involves greater risks - from a regulatory perspective - than in the past and which applied in other jurisdictions where price regulation was in place. The Commission previously concluded that it was reasonable to benchmark the allowable margin against historic decisions by jurisdictional regulators - such as the Independent Pricing and Regulatory Tribunal - and that *'jurisdictional differences between retail energy markets, with respect to the systematic risks faced by energy retailers, was relatively immaterial in the context of our decision'*.<sup>1</sup>

We do not consider the differences in risk profile to be 'relatively immaterial'. At the same time, the calculation of other costs items (such as wholesale costs, an allowance for bad and doubtful and a minimal allowance for acquisition and retention costs) does not account for this. Therefore, we

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<sup>1</sup> Essential Services Commission (2019), *Advice to Victorian Government: Victorian Default Offer to apply from 1 July 2019*, page 83

strongly recommend that the Commission revisit its previous benchmarking approach and reassess retailer margin to identify a return that better reflects the Victorian industry's current risk profile.

### **Maximum annual bill**

The consultation paper discusses the challenges for consumers, retailers and the Commission arising from more complex pricing structures. The Commission states that *'setting VDO tariffs for even a small number of these non-flat variations appears contrary to the objective of the VDO to be a simple and trusted offer available to safeguard customers who are unwilling or unable to engage in the electricity retail market.'*<sup>2</sup> We strongly agree with the Commission on this, as the VDO is intended to be a simple offer. Its composition as a flat tariff allows for this simplicity.

Consistent with our previous position, we consider that the Commission mandates that consumers that take up the VDO are assigned to the comparable underlying flat network tariff. This solution will meet the policy objective for the VDO and removes the risk for retailers in terms of differences in costs under different tariff structures. This approach would also avoid the Commission adding a provision within the VDO to account for the unders and overs relating to tariff differences as they add to retailers' costs.

Further, it would avoid the need for the Commission to estimate or assess usage profiles, which are highly subjective and can vary significantly over time. For example, consumption profiles for residential and small business consumers are heavily distorted at the moment due to COVID-19. The VDO maximum amount is a reference price for consumers on non-flat prices but this comparison will often be misleading due to the underlying assumptions and is unlikely to be the amount that any VDO consumer on a non-flat tariff will actually pay.

Additionally, this could future proof the VDO as the Commission would not have to reconsider this issue every time a Victorian network considers a more complex tariff. Networks have regulatory obligations to implement cost reflective tariffs but the Commission would need to make arbitrary decisions about average usage during different periods - under a demand charge or other complex structure, for example - and decide how to account for highly variable network costs in a way that protects both consumers and retailers. This problem is avoided when all VDO consumers are assigned to a flat tariff.

### **Length of regulatory period**

Our strong preference is for the Commission to set the VDO for a 6 month period and to then align annual VDO determinations with Victorian annual network determinations from 1 July 2021. This avoids the uncertainty of any intra-period adjustment or the need to make an unders and overs adjustment to account for significant changes to network tariffs.

The Australian Energy Regulator's (the AER's) Default Market Offer for 2020-21 illustrates some of the problems that retailers face when regulated retail prices and network determinations are not aligned. The AER was obligated to use estimated tariffs for some networks rather than actual network determinations when it made its final DMO determination in April 2020. It was also unable to

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<sup>2</sup> Essential Services Commission (2020), *Victorian Default Offer 2021: Consultation Paper*, page 15

take account of some new network tariffs that then came into effect on 1 July. It is not clear how the AER will account for this in future DMO determinations, which creates uncertainty for retailers about their ability to recover all reasonable costs.

A good example of this is in South Australia. SA Power Networks proposed a new solar sponge tariff for controlled load customers some time after the Australian Energy Regulator (AER) had made a final determination for the Default Market Offer for 2020-21. As it was unaware of the tariff, the AER couldn't prescribe usage allocations to enable retailers to compare any offers based on this tariff with the DMO.

A further benefit of setting the VDO for 6 months is that the Commission can take account of significant changes that we anticipate will impact the energy sector in the next nine months. This includes:

- Ongoing impact of COVID-19 and its contribution to retailers' operating costs.
- the Australian Energy Market Commission's review of the coordination of generation and transmission investment implementation (COGATI).
- the Australian Energy Market Commission's review of rule change proposals relating to the integration of distributed energy resources and how networks might recover the costs of integration.
- the Energy Security Board's advice to the COAG Energy Council on post 2025 Market Design (including a two sided market) that will influence investment incentives and impact wholesale prices.
- most recent estimates of other regulatory costs, such as AEMO fees, the cost of the Reliability and Emergency Reserve Trader framework, and the Retailer Reliability Obligation.

Red and Lumo do not support the VDO continuing to apply annually from 1 January. This will be inconsistent with the approach by the Commission in setting the VDO and the policy intent of the Victorian Government. Our strong preference is for a 6 month VDO followed by annual resets.

### **Environmental costs**

The Commission should continue to reassess how it accounts for environmental costs in the VDO, particularly those associated with the Small-scale Renewable Energy Scheme. The Commission is aware of the misalignment between the Commission's determination and the Clean Energy Regulator's (the CER's) publication of retailers' liability under the Scheme. This is an important issue that the Commission needs to address irrespective of whether it sets the next VDO for 6 or for 18 months.

The Commission's approach for the previous VDO, in which it took the midpoint of the non-binding 2020 STP that the CER published in March 2019 and the binding 2019 STP, is reasonable as long as the Commission then accounts for the difference between its final decision and the 2020 binding STP in the next VDO. The Commission will be aware that it used a liability of 18.15% in the final VDO, while the actual liability for 2020 was 24.4%.

There is potential for an even larger gap between the allowed and actual liability - and therefore, a larger true-up adjustment at the end of the period - if the ESC sets the VDO for 18 months. This is



another reason why we recommend a 6 month VDO for 2021, followed by a 12 month VDO thereafter.

We have previously provided confidential information to the Commission about the materiality of this cost item. As there is no scope to reduce it through risk management options, it is similar to network costs, AEMO fees and EWOV costs, and must be treated as a pass through. This approach will ensure that the Commission sets a VDO that reflects the actual regulatory costs that retailers face.

### **About Red and Lumo**

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

Red and Lumo thank the Commission for the opportunity to comment on the consultation paper. Should you wish to discuss or have any further enquiries regarding this submission, please call Geoff Hargreaves, Regulatory Manager on 0438 671 750.

Yours sincerely

A handwritten signature in black ink, appearing to read "Ramy Soussou". The signature is stylized with a large, circular flourish at the beginning.

**Ramy Soussou**  
General Manager, Regulatory Affairs & Stakeholder Relations  
**Red Energy Pty Ltd**  
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