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30 April 2025

Essential Services Commission
Level 8, 570 Bourke Street
Melbourne Victoria 3000

By email: VDO@esc.vic.gov.au

Re: Victorian Default Offer 2025-26: Draft Decision

Red Energy and Lumo Energy (Red and Lumo) welcome the opportunity to make a submission to the Essential Services Commission's (the Commission's) Victorian Default Offer (VDO): Draft decision dated 13 March 2025. Our comments are limited to the Commission's proposed change in its methodology for calculating the wholesale cost component. As a general point, it is our view that more analysis of the likely impact of this change, particularly its impact on retailers of different sizes and who differ in the composition of their customer base, is warranted before the Commission adjusts its approach.

The proposed shift in methodology means that retailers will need to adjust their strategies for managing the additional volatility that the growing volume of solar PV across Victoria has created. More specifically, retailers will need to reconsider their feed-in-tariff (FiT) strategies. The Commission's current FiT calculation is made up of the social cost of carbon and the wholesale electricity costs associated with exports. Currently, these two components effectively balance each other out. However, projections indicate an increasing frequency of negative wholesale electricity prices during solar hours, which will lead to a further decrease in the wholesale cost of electricity exports within the FIT. Victorian legislation sets a floor of zero, which limits retailers' flexibility in how they recoup the wholesale costs of solar exports.

We note the Commission is considering alternative mechanisms for capturing these costs in light of the shift away from a balanced profile and the legislative floor for FiTs. One option is an additional element to be included in the VDO to recover the net cost where the wholesale cost of exports surpasses the social cost of carbon. We note, however, that this approach would have the same effect as retaining the balanced profile and maintains the inequity of imposing further additional costs on consumers who are unable to install solar on their roof for whatever reason. These customers are already incurring significant costs through their electricity prices for subsidies provided to customers installing solar.

In general, we support the Commission's efforts to improve its regulation of the VDO. Ongoing improvements to the regulatory process are essential as they ensure the regulation remains fit for purpose. To ensure the regulatory framework remains relevant in the future, regulators should prioritize developing more progressive approaches to regulation in order to improve its efficiency.

However when modifying an existing VDO methodology, it is essential that stakeholders understand the rationale and intent of the changes and their likely impact. This includes the data considered, and the analysis performed to reach the decision. Ultimately, it is important for affected retailers to be confident that the revised methodology is implemented correctly and without unexpected financial consequences.

We have analysed Frontier Economics' calculations to support a potential shift to a load-only position. In our view, the suggestion that retailers are recovering wholesale export costs twice under their balanced approach is inaccurate. Frontier's example indicates only a 3.6% difference in total cost recovery between the load-only and balanced profiles. Given the balanced profile's much peakier shape, requiring retailers to hedge with fewer swaps relative to caps, this difference exceeds the 3.6% identified. This is explored further in Appendix 1.

We are also concerned with the suggestion to include an additional component for the cost and potential risks when export wholesale costs surpass the social cost of carbon and a negative FIT isn't viable. Frontier's modeling indicates that including wholesale electricity export costs as an additional component to the VDO would have a smaller impact on consumer electricity prices compared to the balanced approach. However, it is unclear how this could be accurate, particularly if it aims to capture the wholesale electricity costs already considered in the balanced approach which reflect retailers' hedging costs. In other words, if the adjustment to the VDO is less than the additional cost of hedging the balanced profile then retailers will not be recovering their actual wholesale hedging expenses.

The lack of clarity surrounding Frontier Economics' methodology for calculating the VDO component and how this component is added to the VDO could lead to differing financial consequences for individual retailers. Specifically, we are concerned that the seemingly unfamiliar way this component is incorporated into the VDO may disproportionately affect smaller retailers, potentially hindering competition within the retail market.

Given the previously stated concerns regarding the revised methodology, we believe it is prudent to maintain the balanced approach until the implications of a shift to a load only profile is better understood.

About Red and Lumo

We are 100% Australian owned subsidiaries of Snowy Hydro Limited. Collectively, we retail gas and electricity in Victoria, New South Wales, Queensland and South Australia and the ACT to over 1.4 million customers. Should you wish to discuss aspects or have any further enquiries regarding this submission, please call Con Noutso, Regulatory Manager, on [redacted]

Yours sincerely

Geoff Hargreaves
Manager - Regulatory Affairs
Red Energy Pty Ltd
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Appendix 1

Figure 2: Summary of outcomes – Example 2 – Balance profile

		Load only profile is used	Balance profile is used
Key inputs			
Quantity of imports to supply to customers	MWh	9,273	9,273
Quantity of exports supplied by customers	MWh	2,201	2,201
Balance	MWh		7,072
Average spot price of VDO profile	$/MWh	$85.44	$100.04
WEC component of VDO profile	$/MWh	$91.98	$108.93
Average spot price of FiT profile	$/MWh	$38.52	$38.52
Social cost of carbon (SCC)	$/MWh	$25.00	$25.00
WEC and SCC components of FiT	$/MWh	$63.52	$63.52
Retailer wholesale costs			
Import settlement payments to AEMO	$	$792,253	$792,253
Export settlement payments from AEMO	$	-$84,778	-$84,778
Total AEMO settlement payments	**$**	**$707,475**	**$707,475**
ASX difference payments	$	$60,631	$62,867
Total difference payments	**$**	**$60,631**	**$62,867**
Total costs to be recovered	**$**	**$768,106**	**$770,342**
Retailer tariff revenues			
VDO - WEC component from customers	$	$852,884	$1,010,111
VDO - SCC component from customers	$	$55,028	$55,028
FiT - WEC component to customers	$	-$84,778	-$84,778
FiT - SCC component to customers		-$55,028	-$55,028
Total cost recovery	**$**	**$768,106**	**$925,333**
Outcome			
Revenue minus costs	**$**	**$0**	**$154,991**

Frontier Economics' paper acknowledged the fact that the Balance profile resulted in significantly higher WEC component of VDO due to less swap and more cap is required for hedging the netted load profile. The difference of WEC in the quoted example is equivalent to $16.95/MWh (= $108.93 - $91.98). This is justified by the difference of daily average demand 386MW (= 9,273MWh / 24 hours) against the Balance profile daily average demand 295MW (= 7,072MWh / 24 hours), but the same maximum demand of the day (happens after sunset, with solar export close to zero) is required to be hedged by cap above the average daily demand.

As the export supplied by retail customers (mainly from roof top solar PV) is highly weather dependent and retailer should have bought additional caps to cover the peakier Balance profile, an additional wholesale hedging cost between $157,177 (= $16.95/MWh x 9,273MWh) and $119,870 (=$16.95/MWh x 7,072MWh) above the Load only profile is expected for the quoted day of Frontier Economics' example.

The incremental cost of Total difference payment quoted in the illustrated example was only $2,236 (= $62,867 - $60,631) for the day. As Frontier Economics claimed in the report, this amount has taken into account the additional cost of hedging due to the Balance profile consideration. However, as this amount was well short of the range $157k and $120k as determined by the WEC unit cost ($/MWh) times the volume of the day, this doesn't seem to the reasonable, or the cost of buying additional cap for the Balance profile is probably omitted in Frontier Economics calculation.