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Victorian Default Offer – Staff Paper

Meridian Energy Australia Pty Ltd and Powershop Australia Pty Ltd (**MEA Group**) thank the Essential Services Commission (**ESC**) for the opportunity to provide comments in relation to the staff paper - *Victorian Default Offer for domestic and small business electricity customers (Staff Paper)*.

MEA Group considers it appropriate that all proposals and methodologies relating to the Victorian Default Offer (**VDO**) be measured against the Government's stated policy intention as stated in the Fair Pricing in the Energy Market – Terms of Reference for the Essential Services Commission:

"a simple, trusted and reasonably priced electricity option that safeguards consumers unable or unwilling to engage in the retail electricity market without impeding the consumer benefits experienced by those who are active in the market."

This will require a careful balancing of the trade-offs between simplicity and protection for those unable and unwilling to engage in the market against the impact on consumers. It is important to note that the Terms of Reference require the ESC not to implement a VDO which will impede consumer benefits by those who are active in the market.

MEA Group considers that the critical underlying outcome of the initial VDO is that it produces fair outcomes that benefit all customers. This requires consideration of the impact on various customer classes (solar vs. non-solar, engaged, dis-engaged & vulnerable, price vs. non-price focussed, flat & varying usage profiles, and residential vs. small business), the impact of short-term and long-term outcomes, particularly associated with the need to ensure long-term investment necessary for positive customer outcomes to occur and the impact on incentives for networks & retailers to continue to reform network pricing.

In addition, it is important the VDO continues to produce fair outcomes overtime that benefits all customers post-implementation. The MEA Group supports the ESC's view that the VDO methodology will be regularly reviewed and updated, taking into consideration changes in the market over time and sudden impacts resulting from regulatory and market interventions. The ESC should monitor and regularly report on the effectiveness of the VDO, including customer movements from standing and market offers to the VDO by customer class.

The MEA Group recognises the time-constraints imposed to publish the first VDO methodology and pricing, and the practical approach to utilise the methodology and knowledge gained through the

March 2018 process to calculate a reference price for Victoria's electricity retail market. It would be beneficial, and necessary to ensure transparency, for the ESC to release the full methodology, assumptions and calculations used in the 2018 reference price process. This will provide further understanding and transparency as to the starting point for the VDO, so the methodology for setting and re-setting the VDO is clear and understood. If the implementation relies on broad-based & inappropriate assumptions, reference to historical & not representative benchmarks, whether due to complexity and/or time constraints, it will lead to an inaccurate price, and subsequently lead to customer confusion, potential inequities in price setting, and a wary investment community.

1. Is the definition of a notional retailer suitable for the Victorian retail energy market? What alternatives could we consider for the VDO?

We are generally supportive of the proposed definition of the notional efficient retailer, however have some concerns around one of the elements. In particular, basing the notional retailer on one that has achieved economies of scale raises the prospect that a smaller retailer's ability to compete with larger incumbent retailers will not be reflected. Clearly, such a result would impede benefits available to consumers active in the market who currently receive either lower prices from smaller and new entrant retailers or access to more competitive offers from incumbent retailers responding to such offers. This would be inconsistent with the Terms of Reference.

2. Please provide your views on the time period, buying curve and load profile that are most suitable to the Victorian electricity market

Wholesale costs – some issues to consider

Price Shape & Volatility - New generation and behind the meter resources and technology have increased rapidly in recent years resulting in the price shape changing. There is every expectation that it will continue to change in the near future. This change, mainly due to the uptake of rooftop solar and batteries, will be exacerbated in Victoria by the Government's new solar incentive schemes. It has led to a peakier, more volatile market (higher proportion of peak, with a sharper, narrower peak, later in the day). This has the consequence that retailers have to cover the costs of dealing with this peak, with less average overall load and revenue. A prudent and efficient retailer will build a hedge book and pricing strategy anticipating these trends to continue. Therefore it is important to assess and allow for these recent and expected changes and impacts on the future spot price shape and volatility.

Time period to estimate forward contract prices – MEA Group generally supports the utilisation of a rolling average view of the visible forward curve relating to Base Swaps as a proxy for spot price outcomes, as is generally supported across the industry. However, it should be noted that the contract market includes hedging of all market loads, including large, flatter commercial & industrial customers.

It is important to note that different retailers will opt for different hedging strategies based on their overall risk appetite, corporate & funding structures, access to physical generation (vertical integration structure and strategy), business lifecycle and strategy. There is obviously no 'right' or 'wrong' approach or market norm. Practically there will be a spectrum of hedging strategies, from progressive hedging (various timings and volumes) over a long period (potentially greater than two years) to hedging entire forecast load concurrently with the time of setting customer prices. For example, it has been estimated by market observers "that in setting the annual retail tariffs, AGL/ORG uses the 'year-ahead' forward curve, averaged over the 11 months prior to the start of each fiscal year, to reflect the wholesale power price input".¹

¹ Bank of America Merrill Lynch report "Australian Utilities - The last hurrah is behind us" 11 April 2018

When considering the timeframe and volumes included in the prudent retailer’s efficient portfolio, a trade volume-weighted approach should be used, with additional weight for more recent and market reflective trades. An alternative approach could use the higher of the weighted average hedge book for the prior 11 months or the two months before setting the VDO.

However, without disclosure of the detailed assumptions and calculations of determining a “contract premium” (noted as “five per cent on underlying prices”) it is difficult to assess. Comparing the average Calendar Year Base Swap prices in the month of November prior to the commencement of the Calendar Year against the actual wholesale spot outcomes mostly shows the opposite. That is, for Base Swap the pool outcomes were often settled above contract prices (i.e. additional amount should be added to the Base Swap price).

Base Swap Difference to Spot Outcomes \$/MWh	
2015	\$ 2.17
2016	\$ 9.03
2017	\$ 28.22
2018	\$ (18.84)

Use of MRIM data & load shape – The proposed approach to use MRIM data provided by AEMO assumes incorrectly that all retailers have the average of market load shape. This is clearly not the case as different retailers service and target different market segments. As an example, a new entrant residential-only retailer may face higher energy costs (riskier or peakier average load shape) than an incumbent retailer with a flatter load shape with a mix of residential, business and C&I customers. Also as with price shape, load shape is changing and will continue to change over time. This can be seen in the changing load shapes in the load profile (based on MRIM data, which includes all segments) for the distribution areas with large penetrations of solar PV and will be further pronounced with increased solar PV uptake in the future. This change is clearly observable in the current data even though less than 20% of households currently have solar PV. A retailer with particular exposure to solar PV customers (e.g. DC Power Co which is focussed primarily on solar PV households) would face substantially greater risks. The ESC should consider the inclusion of a solar VDO in future to allow for this divergence (noting this may also be required with changing network tariffs in this area).

The proposed approach should utilise 30 minute interval data that segments customers into residential and small business (less than 40MWh) by distribution area. The Victoria network companies indicated at the VDO workshop that this data could be provided using network tariffs for the two distinct segments. This will provide undistorted raw data.

Load premium – While on a market basis, the market load premium may be consistent and known, at an individual customer and retailer level the situation is more complicated and volatile. A prudent retailer will assess the load premium for their portfolio, the possibility that the peak load does not occur at the same time as the peak pricing and the possibility that the forecast change in their customer usage may not match the system average. This is all in the context of in home appliance usage, solar, battery & EV uptake,

the price of gas, and the distinct impact on the retailer of economy wide variables.

Aggregate load and customer numbers – The proposed approach is appropriate for a market wide assessment of costs, where overall load is relatively consistent. However, retailers are either growing, stagnant or declining, by indeterminate amounts. Making assumptions about the level of hedging in the proposal is inappropriate. There is a significant financial risk associated in customer numbers not meeting forecasts and there are significant costs in arranging appropriate hedging to manage that risk.

Efficient portfolio – Frontier’s proposed approach utilising the STRIKE model to determine an economically efficient hedging portfolio assumes perfect foresight and needs to be based on a prudent retailer’s view on risk and therefore loss they are willing to absorb. However, the risk appetite of Victorian retailers is very disperse, reflecting the different customer size, load and segments held, integrated wholesale positions, debt & equity mix and sources, additional income streams etc. Taking the most conservative, risk-averse approach seems reasonable.

In addition, contract types with low liquidity in exchange trade markets (e.g. Peak Swaps) are a good indication that retailers (and other participants) are not utilising them in their portfolios. Therefore, the proposed model should ensure that these contracts are not overly representative in any portfolio.

In summary, the situation is more complicated than the proposed approach contemplates. A prudent retailer needs to manage the above factors; an allowance for these factors needs to be included over and above the cost proposed which assumes perfect foresight. The proposal to add a volatility risk premium to allow for all these additional risks is understandable however needs further analysis.

Other wholesale costs

MEA Group notes that the proposed approach in relation to a number of additional costs classified as “other costs” should be calculated and transparently detailed as per industry norms, and assigned as wholesale costs. For example:

- brokerage fees and other hedging transactional costs;
- AEMO market fees and ancillary costs (noting volatility changes over time);
- AEMO Victorian Reliability and Emergency Reserve Trader (**RERT**) costs - significant demand side management costs imposed on all Victorian retailers by AEMO (which will increase over time);
- AEMO and distributor prudentials; and
- other working capital considerations - for example, futures contracts are purchased prior to the start of the relevant trading period, however only “pay out” during or at the end of the quarter).

3. How should the commission calculate transmission losses?

MEA Group notes that transmission loss factors should be calculated on a weighted average basis for residential and small business (under 40MWh) separately.

4. Are the tariffs set out in Tables 1 and 2 the appropriate tariffs to use for establishing the VDO?

5. How should we treat the calendar year network revenue determinations in the context of the introduction of the VDO from 1 July 2019?

MEA Group notes that the proposal to use a singular simple tariff per network area for simplicity will cause some level of dispersion of costs and cross subsidisation that may negatively impact certain customers and customer types. MEA Group notes that the ESC

should consider calculating network tariff costs on a weighted average basis for residential and small business (under 40MWh) separately. While this approach will still have some level of cross-subsidisation it should result in a fairer distribution of costs over time, as the weighted average is calculated on actual VDO customers. In addition, failing to take into consideration the existing and planned dispersion of network tariffs, will lead to the inability of the “cost-reflective” tariffs to effect actual customer behaviour.

Environmental costs

LGC & STC pricing – The proposed market-based approach utilising the visible forward market will provide a good indication of expected LGC and STC prices. Consideration should be given to the analysis of the volumes traded and movements in the forward prices. This is particularly relevant for later periods with limited trades and greater uncertainty of potential outcomes (e.g. due to uncertainty over construction and policy), where these thin markets are less likely to be reflective of real expected outcomes.

LGC & STC % – The proposed approach does not take into consideration the increasing calendar year requirements to surrender LGCs and STCs. In addition, the percentage to be surrendered changes annually after the start of the calendar year and after the usual annual change in retail offers. Therefore, retailers need to take a view on the expected change and thus risk not pricing this into the retail price. The increase seen in 2018 was large – and arguably larger than had been anticipated by most retailers:

Year	LGC renewable power percentage	Small-scale technology percentage
2017	14.22%	7.01
2018	16.06%	17.08 ²
% Increase	13%	143%

The size and volatility of these price changes are likely to increase even further due to Government action and policy, including the Victorian Government Solar Homes policy and a potential Labor Federal Government’s commitment to more ambitious emissions reductions.

6. Do you agree with our proposed approach of using benchmarking? If not, why not, and what alternative approach should we consider?

7. What should be included as efficient retail operating costs and a modest customer acquisition and retention costs allowance?

8. For electricity retailers – how readily can you separate customer acquisition and retention costs from other operating costs? What issues might we need to consider?

MEA Group understands the proposed approach to use benchmarking to ascertain retailers costs and margins, including cost of acquisition and retention costs based on the timeframes that have been imposed. However, the interim approach of utilising historical, regulatory benchmarks from NSW and/or the ACT to inform retail operating costs may result in gross misrepresentations of current costs for an efficient retailer in Victoria. This has the potential to lead to a VDO that does not accurately reflect real

² Non-binding STP (published previous year) was 8.06%.

costs, leading to further customer confusion, and investor wariness.

The ESC must account for differences in the benchmarks due to location or jurisdiction (e.g. regulatory costs incurred only in Victoria, noting as that the ACCC report stated that Victorian retailers face higher regulatory costs due to the failure to implement the NECF)³ and time (e.g. new RERT costs and increased risks due to government intervention) to inform the calculation of a Victorian specific retailer cost. Without a clear, transparent understanding of how the benchmark costs are related to Victoria in 2019 it is difficult to assess the benchmark approach.

The ESC's long term approach to use a bottom up cost method is reasonable. However, again without further information of the method proposed it is difficult to assess. It is unclear when and if the government will provide these powers to the Commission. In addition, it is unclear how the Commission will clearly identify, classify and interpret various costs, which are not consistently applied across all retailers.

The breakdown of costs set out in the Staff Paper relating to cost to serve and customer retention and acquisition costs seems reasonable. The ESC needs to clarify the quantum and calculation of "modest" that it proposes for both acquisition and retail costs. It should be noted that depending on the size, location, structure and sophistication of a retailer, it is unclear as to whether these costs can be allocated specifically to small business and residential customers. In addition, in relation to retailers with non-electricity revenue sources (e.g. gas, energy-related products, broadband etc.), it is difficult to separate out and allocate various costs, including general marketing to a customer segment of the electricity business. Depending on the size, make up of customer base, level of vertical integration, operating model and strategy, retailers will have differing costs and allocations amongst their product offering to recover these costs.

When determining the retailer operating costs, it is important to allow for a level of cost that retailers increasingly incur in providing new, innovative products and improving existing customer experience and service. Noting new entrant retailers need to differentiate based on product and/or service and therefore are exposed to higher operating costs than their established competitors. This is further compounded by the impact of economies of scale. Accordingly, if the VDO is to not stifle competition and innovation, it is important that the benchmarks do not eliminate the opportunity for small, innovative and new retailers to participate in the market.

9. Are there any other costs incurred by an electricity retailer that we should consider? Why?

See above (e.g. new RERT costs).

10. Does this proposed structure provide a simple and practical approach to deal with the variety of standing offers?

11. What other approaches to cost allocation would you consider appropriate?

MEA Group suggests a weighted average approach should be used in allocating network tariffs. Initially, this could be on the basis of existing standing offer customers, transitioning to real VDO customers in future VDO calculations.

MEA Group notes that there are a number of transitional and practical implications for the introduction of the VDO that have not been assessed, consulted upon or clarified by the ESC, the Government or the Staff Paper such as:

1. The measurement of marketing retail discounts

³ ACCC Retail Electricity Pricing Inquiry - Final Report Recommendation 26.

It is unclear how the marketing discounts will be calculated, displayed to customers and interact with conditional discounts. In addition, it is unclear how this will be monitored and compliance assessed.

2. Transition and price change

It is unclear how VDO customers will be transferred from standing offer contracts to a VDO contract and how the government imposed price change (potential price increase for some) will be communicated.

3. A transition period where an initial retail operating margin is reduced at each subsequent price re-set.

It is unclear what the rationale for this position is, considering that it does not align with the characteristics of the ESC's proposed "notional" retailer who is considered to be an efficient market participant, nor how it will be calculated in the future.

4. Integration with upcoming regulatory changes following recommendations in the Thwaites Review, stated Government policy intention and ongoing ESC work.

It is unclear how the implementation of the VDO will interact with and complement forthcoming regulatory changes, for example:

- interactions with new requirements relating in the provision of clear advice and best offer; and
- requirements for retailers to fix customer prices for a minimum of 12 months in all market offers – will the VDO be updated on a monthly basis and for contract terms greater than 12 months to ensure that VDO contract pricing is in sync with market offers?

If you have any queries regarding this submission, please do not hesitate to contact me.

Yours sincerely,



Ed McManus
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Powershop Australia Pty Ltd & Meridian Energy Australia