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Essential Services Commission
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Dear Essential Services Commission

Victorian Default Offer to apply from 1 July 2019

Meridian Energy Australia Pty Ltd and Powershop Australia Pty Ltd (MEA Group or Powershop) thanks the Essential Services Commission (ESC) for the opportunity to provide comments on the ESC's Victorian Default Offer to apply from 1 July 2019 draft advice (VDO).

The MEA Group is a vertically integrated generator and retailer focused entirely on renewable generation. We opened our portfolio of generation assets with the Mt Mercer and Mt Millar wind farms. Subsequently, in early 2018 we acquired the Hume, Burrinjuck and Keepit hydroelectric power stations, further expanding our modes of generation. We have also supplemented our asset portfolio by entering into a number of power purchase agreements with other renewable generators, and through this investment in new generation we have continued to support Australia's transition to renewable energy. Powershop has also been active in supporting community energy initiatives, including providing operational and market services for the community-owned Hepburn Wind Farm, supporting the Warburton hydro project, and funding a large range of community and social enterprise energy projects through our Your Community Energy program.

Powershop is an innovative retailer committed to providing lower prices for customers and which recognises the benefits to customers in transitioning to a more distributed and renewable-based energy system. Over the last five years, Powershop has introduced numerous new, innovative and customer-centric initiatives into the Victorian market, including the first mobile app that allows customers to monitor their usage, a peer-to-peer solar trading trial and a successful consumer-led demand response program.

The proposed VDO will not produce a fair outcome for all consumers, nor will it achieve the Government's stated policy intentions

Powershop does not support the proposed VDO as we consider that it is highly likely to have an adverse impact on customers in terms of price, access to competitive and innovative offers, and reliability. We also consider that it is highly likely that the VDO will reduce innovation, customer service and the investment in required renewable generation. In addition, it is likely to also cause a decline in competition across the entire Victorian energy sector and detrimental consumer outcomes.

This view is supported by the AEMC in their 'Advice to COAG Energy Council: Customer and competition impacts of a default offer'. The AEMC found that a reduction of 10% in the average standing offer in some regions would likely require retailers to increase their market offers to above the new standing offer rate.

Further details of the likely impact of the proposed VDO on customer benefits and competition impacts are also set out in the Australian Energy Council's submission on the VDO which we fully support.

The Victorian Government's policy intention as stated in the Fair Pricing in the Energy Market – Terms of Reference for the Essential Services Commission (ToR) is for the VDO to deliver:

> *"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."*

We acknowledge that the decision to develop a VDO was not the ESC's and that the ESC is required to implement the proposed VDO. However, in implementing the VDO the ESC should be guided by the National Electricity Objective (NEO) and the Victorian Government's stated policy intention.

Powershop believes that the VDO as currently designed by the ESC does not achieve the NEO objective nor will it be in the long term interests of Victorian consumers. The proposed design will impede the consumer benefits experienced by those who are active in the market, and therefore it is inconsistent with the ToR.

The NEO has been adopted market-wide by all jurisdictions including the Victorian Government. In particular, the NEO requires a focus on the promotion of:

> "*efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:*
>
> - *price, quality, safety and reliability and security of supply of electricity; and*
> - *the reliability, safety and security of the national electricity system."*

1. TERMS OF REFERENCE

<u>Key terms of reference have been ignored or not followed</u>

The ESC has not addressed the ToR. In particular we note the following:

- Under the ToR the ESC is directed to "include a modest allowance for customer acquisition and retention costs" (CARC), and for this "to be based on current marketing standards and approaches". The ESC has incorrectly modelled the CARC on a future, utopian market where "we have sought to imagine what a market might look like when customers are highly engaged and willing to rapidly switch".

  Not only does the ESC approach not address the ToR it also fails to account for the current expected costs of CARC for a Victorian retailer. Powershop suggest this should be as per the ACCC data for existing Victorian practices not based on national, non-Victorian data as proxy for the future post-VDO world. The ESC must review their modelling and base it on current marketing standards and approaches as is required under the ToR.

- The ToR also requires the ESC to develop a VDO model that does not impact customers already "active in the market". The current design of the VDO will impact and penalise some customers that receive benefits from current market offers.

  We believe that this requires the ESC to consider the inherent risks of adopting a simplified approach (e.g. it will not allow for the impacts of non-single rate tariffs, it excludes time of use and solar & demand customers). The model may inadvertently result in a VDO price being set too low and create an unfair cross-subsidisation effect.

  It is also concerning that the proposed prices are at, or approaching, the levels that the AEMC considered likely to effectively eliminate competition and result in engaged consumers losing most, if not all, of the advantages of the competitive market.

- The ESC is required under the ToR to "have regard to its objectives" under the both the *Electricity Industry Act 2000* (EIA) and the *Essential Services Commission Act 2001* (ESC Act):

    - Section 10(a) of the *EIA*, states that "The objectives of The Office under this Act are to promote competition in the generation, supply and sale of electricity". It is highly probable that the current VDO model will result in reduced competition and on that basis the objectives of the ToR are not being appropriately focused on by the ESC nor are they carrying out their duties under the *EIA* effectively.

    - Section 8A of the *ESC Act* outlines specific matters that the ESC must have regard to when addressing the VDO ToR. Specifically, the current VDO model fails to allow for "efficiency in the industry and incentives for long term investment" based upon the cost elements described on page 16 of the draft advice. The ToR are not being adhered to in this instance as it highly likely that energy retailers will exit the Victorian market under the proposed model.

      Powershop also believes that the ESC has failed to consider "the degree of, and scope for, competition within the industry, including countervailing market power" as is required under section 8A(c) of the *ESC Act*. In basic terms a shrinking competitive market under the VDO acts as the opposite to countervailing market power and will only strengthen those already substantially embedded in the market.

    - Evidence of the failure of the ESC to appropriately address its obligations under the ToR in relation to competition and impact on consumers can be found in the AER letter of advice to the Federal Government on the protection of consumers under the VDO, dated 22 March 2019 and in the ACCC submission to the AER on the proposed DMO referenced therein.

      In particular the ESC should take strong heed of the ACCC's advice which stated that:

      > "*The ACCC does not want the DMO to become a viable alternative for engaged consumers that can find good deals. Engaged consumers drive efficiency and innovation in the electricity sector by responding to new offerings from retailers. Losing this engagement would result in less effective retail competition and is unlikely to be in the long-term interest of consumers".*

    Contrary to this advice the ESC has set the VDO at such a level that it will result in less effective retail competition and it is unlikely to be in the long term interest of consumers.

2. PROPOSED APPROACH FOR THE VDO

<u>The ESC should be cautious in developing the initial VDO</u>

In light of the AEMC advice, and its focus on competition and investment impacts, and the potential for material, irreversible detrimental effects, it is imperative that the ESC in first implementing the VDO takes a cautious approach to setting the initial VDO prices.

<u>Allowance for long term investment in product development, customer experience and efficiency in service delivery must be included</u>

One of the Government's stated policy intentions is to eliminate barriers to the use of smart meter data to encourage innovation from retailers.[1] Retailers, including Powershop, have consistently incurred costs for innovation and development to improve customer experience, service standards and product options, including the provision of additional insights into usage and costs, better customer service and cost reduction programs which ultimately reduce energy bills.

[1] Victorian Government Final Response to the Independent Review of the Electricity & Gas Retail Markets in Victoria

These innovations have historically been built off the use of smart meter and other customer data. These costs are essential to enable Powershop to compete not only on price but also deliver the innovation which is driving long term market-wide customer benefits including lower costs and reduced consumption. Consideration of these costs is especially important during the current energy market transformation which is increasing reliance on renewable energy and decentralising participation, as the market will become increasingly reliant on retailer led innovation such as demand response, virtual power plants and peer- to-peer trading.

It is in light of these innovation requirements that the ESC must include an additional allowance over and above the determination of the cost to serve currently allocated in the VDO. Note these costs are not "headroom", but real, actual costs spent by efficient retailers competing in a highly competitive market. The ESC should advocate a VDO that enables this future investment, a model that would also endorse the current Victorian government's policy of transferring from a traditional centralised thermal generation industry to a more renewables based and decentralised energy industry. The VDO currently fails in its approach to address incentives to continue to invest in the drivers for this critical long term investment.

Unless a cautious approach is adopted there is a very real risk that the proposed VDO will drive many small and competitive retailers out of the Victorian market or at a minimum reduce the benefits of their offers to consumers. This would have the counter-productive impact of reducing the market back to a few large players who have high name recognition and who do not need to invest as much in customer acquisition to compete.

Effectively eliminating smaller retailers, who not only compete on price but also on service and innovation, the proposed VDO does not provide customers with the best available market options that would otherwise be available. If the VDO only addresses those costs outlined in the current model, the average decrease in revenue per customer for non-Tier 1 retailers and new entrant retailers will be disproportionately affected resulting in a larger impact on these retailer's revenue streams. The current model will also significantly impact retailers who are not vertically integrated with generation and wholesale assets, as they have a limited ability to respond to market movements with far greater variances in their revenue streams.

3. ESTIMATION OF THE VDO

Wholesale costs must reflect real-world experience and risk management methodologies

Powershop would like to make the following comments on the estimation methodology used in relation to the wholesale cost component in the VDO:

(i) Neither the ESC or Frontier Economics have demonstrated how the methodology used in the determination of the wholesale component in the VDO would have performed historically – i.e. would it have reasonably estimated wholesale costs for a representative retailer? The methodology used is a highly theoretical, academic model with no demonstrated real-world application.

(ii) As acknowledged by the ESC, the MRIM data used is inclusive of larger business customer loads (up to 160MWh usage) which are not subject to the VDO (less than 40 MWh usage). These business customers have a significantly 'flatter' profile than residential customers – retailers without a proportional business portfolio would likely be disadvantaged by this.

Frontier Economics acknowledged this and suggested the impact is small ("the WEC would differ by a couple of dollars per MWh"). Powershop does not agree with Frontier's assessment. If Frontier applied $2/MWh across the customer base on the 'allowance for a maximum retail profit' of 5.7% then the significance is far greater than their assumption. Powershop suggests that the methodology should be re-run to produce separate wholesale costs for residential and small business customers, to ensure retailers are not disadvantaged and to limit cross-subsidisation between customer segments with differing wholesale cost profiles. Powershop would be willing to discuss this further with the ESC to achieve more reflective wholesale costs.

(iii) The most recent MRIM data used in the determination of wholesale costs is the 2016/17 financial year. Net profile shapes have changed noticeably since that period as a result of continued integration of small scale renewables, which have been heavily promoted by the government. This primarily acts to increase hedging costs due to the higher ratio of peak to average load and a higher load variance.

(iv) The methodology proposed by Frontier Economics considers serving the same customer base across the year. In reality, most smaller retailers which compete with the incumbent retailers have significant fluctuations in customer growth patterns throughout the year which creates a volume risk for most non-Tier 1 retailers.

(v) In a rising wholesale market, there may be increased demand from consumers transferring from market offers (potentially 12-month fixed term contracts as the government has indicated should be mandatory) to the VDO price. This may result in retailers incurring losses for incremental customers even alongside effective hedging practices. This will result in retailers being required to hold greater amounts of capital for such periods and an increase in financing and hedging costs which will ultimately be borne by consumers who currently have the benefit of market rates below the proposed VDO.

(vi) There is uncertainty over how peak demand is defined in the VDO due to the nature and lack of transparency of the Frontier Economics approach. It is understood however that the ASX $300 cap product is only represented to an amount that is below the highest observed historical peak demands.

Many retailers hedge to maximum historical demand to avoid excessive capital exposures and cash flow complexities associated with more-extreme market events. Powershop believes that the ESC should be cognisant of the fact that many retailers are required to be risk-averse and cannot reasonably be expected to incur excessive costs associated with not hedging to at least historical peak demands.

(vii) The Frontier Economics model calculates the efficient cost of a retailer using historical load and price data across a five year period. This approach may provide the best economic outcome for pricing customers over a period of five years however it does not account for the volume and price variance between years. Retailer costs will be higher in higher demand years with higher prices in peak periods when compared to the average year. We estimate this cost to be ~$5/MWh.

(viii) The VDO is incompatible with the Retailer Reliability Obligation (RRO). The VDO assumes a time-weighted bookbuild of contracts across a 12 month period. The RRO requires retailers to be hedged to their one in two forecast peak demand one year in advance of a reliability gap period. A prudent, efficient retailer would be required to enter into hedges to meet the RRO obligations and would need to do so in the 6-12 month period prior to it taking effect. This requires hedges to be entered into on average 18 months prior to rates taking effect and not six months as assumed by Frontier Economics.

The issues raised above in relation to wholesale costs are not new and indeed the ESC has previously acknowledged the items we have raised. It is concerning that we need to continue raising these issues due to the fact that the proposed VDO is silent on these. We would ask the ESC to seriously consider our comments in relation to the flawed usage of MRIM data, its relevance given its age when load profiles have since changed dramatically and the use of appropriate hedging methods, particularly related to the RRO and mitigating potential customer churn to the VDO.

If the VDO moves ahead in its current form then the flaws in applying wholesale costs could materialise within the next six to 12 months with a probable price increase for VDO customers. The VDO will increase due to current market dynamics. It is likely that some Tier 2 and 3 retailers may be forced to exit the market as a result. This would significantly erode consumer confidence in the overall VDO scheme, regulatory framework and the Victorian energy system.

<u>The draft decision is inconsistent with the information presented by the ESC</u>

At the VDO seminar on 26 March 2019, the Chairman of the ESC, Dr Ron Ben David, expressed the view that the ESC expected that the proposed VDO would not be expected to have any effect on market offers below the VDO. However the ESC report expresses the view that the proposed VDO will enable retailers to maintain their current retail margins. It is impossible for both of these statements to be true.

The VDO will result in retailers reducing margins to the VDO level (i.e. 5.7%) for VDO offers and in all likelihood for offers currently above the VDO. The only way for a retailer to achieve the VDO level of margin will be to increase all remaining offers to the VDO level. Either the ESC expects retailers to remain in the market with a retail margin below that which it considers fair or it recognises that customers will lose access to all benefits from participating in the market. We note again that neither outcome would be consistent with the ESC's ToR.

In determining the VDO the ESC has utilised flat network tariffs for simplicity. In doing so, it has completely ignored the government's and the industry's drive towards more cost reflective tariffs to drive consumer behaviour. As these new tariffs are intended to incentivise customer behaviour they tend to reward positive behaviour and penalise negative outcomes. Failing to consider these tariffs in the VDO raises the very real risk that either retailers or non VDO customers will bear a greater proportion of these costs, with the consequence that they are cross-subsidising VDO customers (and other flat network tariff customers priced off the VDO).

In addition to the ESC's failure to price CARC on the basis of existing marketing standards and approaches we note that it has based retail costs on ACCC average data plus a small allowance for Victorian regulatory costs. However, this data is now substantially out of date and does not include significant increases in costs that retail businesses have incurred since the data was submitted including the cost of responding to various government and rule initiatives (eg Power of Choice, Payment Difficulties Frameworks, 'best offer' on bill requirements and Consumer Data Rights).

In addition, the ACCC data does not appear to include the significant investment costs involved in system improvements necessary to ensure that customers can achieve the long term benefits from access to new initiatives and new technologies. Failure to include this investment would be contrary to the ESC's ToR under the ESC Act.

It is unclear whether cost to serve assumptions (or wholesale risk assumptions) take into account further increases over time in regulatory costs, bad debts and working capital requirements (including prudential costs) due to cost of living and macro-economic pressures, increased regulatory requirements and increased customer enquiries (e.g. in response to the government's stated policy intentions).

As an example, use of the ACCC cost data assumes that the same number of customers contact a retailer each year, yet the Federal Government is currently running a multi-million dollar advertising campaign to encourage every customer to contact their retailer. In addition, the intent behind the proposed 'best offer' on bill regulatory changes is to encourage customers to contact their retailer. Both of these examples are likely to result in significant retailer costs which are completely ignored in the ESC analysis and subsequent VDO model.

4. OTHER CONSIDERATIONS

New government initiatives should be allowed time to deliver the government's intentions

Powershop provided a submission to the ESC's Staff Working Paper on 30 January 2019 raising concerns and questions concerning regulatory implementations running parallel to the VDO and its implementation. The draft advice fails to provide further clarity on the items we raised which is disappointing.

It is very important that the new VDO compliments and respects the subsequent regulatory requirements concerning 'best offer' on bills as well as the clear advice requirements, and the complex interactions these requirements will have. Significant testing, planning and implementation will be required to ensure the VDO interacts well with, and does not counteract, the other recommendations' ability to deliver benefits effectively for consumers.

We also raised an issue in relation to price change, where retailers are required to fix prices for all market offer customers for 12 months, and asked if the "VDO will be updated on a monthly basis and for contract terms greater than 12 months to ensure that the VDO contract pricing is in sync with market offers". The draft advice does not address this issue which is disappointing as a response for industry is necessary and should be provided.

In light of the above, we consider that progressing with the current VDO draft advice would be inconsistent with the ToR and we also believe that it is inappropriate for the ESC to proceed with the proposed VDO prices. In particular, we strongly urge the ESC to consider setting VDO prices higher for the initial VDO period. In addition, the ESC should monitor the impact of the initial VDO and other new regulations to determine whether continuing the VDO would have merit or that the re-setting of standing offer amounts and the new regulations are sufficient to meet the government's objectives. The ESC clearly has the ability under the ESC Act to adopt a proactive approach in relation to proposing that it conduct inquires of this nature.

Adopting this more cautious, considered and measured approach would allow the ESC to proceed while reducing, but not eliminating, potential impacts on prices, competition, innovation and investment. We encourage the ESC to seriously consider the potentially significant adverse effects on Victorian consumers, the energy market and ultimately the Victorian economy.

If you have any queries or would like to discuss any aspect of this submission please do not hesitate to contact me.

Yours sincerely,

Ed McM.

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