



Meridian Energy Australia Pty Ltd

Melbourne VIC 3000

17 April 2018

Energy Services Commission of Victoria
Retail Energy Review
RetailEnergyReview@esc.vic.gov.au

Submission on Consultation Paper – Developing a reference price methodology for Victoria’s energy market

1. Background

Meridian Energy Australia Pty Ltd and Powershop Australia Pty Ltd (Powershop) (together the MEA Group) provides the following submission to the Energy Services Commission of Victoria (the Commission) in relation to the Consultation Paper – Developing a reference price methodology for Victoria’s energy market (Paper).

Powershop operates an electricity retailing business in the National Electricity Market, with over 60,000 customers in Victoria. Powershop was recently ranked Australia’s Greenest Power Company in the Greenpeace Green Electricity Guide for the third time and has been awarded Canstar’s Most Satisfied Customers Electricity Providers - Victoria for three years running.

Powershop is based in Melbourne and its ultimate parent Meridian Energy Limited, is an exclusively renewable generator, and has one of the Australasia’s largest renewable-only generation portfolios. In Australia, the MEA Group owns the Mt Mercer Wind Farm (a 131MW generation facility near Ballarat, Victoria) and Mt Millar Wind Farm (a 70MW generation facility in South Australia), and is the registered generator for and assists with the operation of the Hepburn Wind Farm (in Daylesford, Victoria). The MEA Group recently made significant investments in additional renewable energy facilities to support the transition to a lower carbon energy market as a direct result of the growth of Powershop. This is important as it clearly evidences the strong link between generation investment and open and competitive retail markets.

The investments included the purchase of the Hume hydro power station in Northern Victoria, the Burrinjuck hydro power station and Keepit hydro power station in NSW and entering into power purchase agreements with the Salt Creek Wind Farm and the Kiamal Solar Farm in Victoria and the Crudine Ridge Wind Farm in NSW.

As we have previously submitted, retail competition has been somewhat effective in Victoria, with many good examples of innovation (in the last 12-24 months in particular), customer service improvements and lower prices as a result of competition. Powershop has delivered a number of innovations to the market, including:

- the first phone app giving customers information on electricity usage and cost;
- the first retailer to deliver carbon neutral products to the market;
- the first at scale demonstration of peer to peer solar trading;

- at scale rollout of residential demand response; and
- at scale rollout of a virtual power plant offer.

Despite Powershop’s broad support for the bulk of the recommendations in the Independent Review of the Electricity and Gas Retail Market in Victoria (the Review), we are extremely disappointed by the lack of both formal and informal opportunities to comment and provide feedback on the Review Panel’s (the Panel) findings. Due to the absence of that opportunity, we have set out below some brief comments on the methodology and conclusions of the Review.

- The Review makes broad conclusions on the market post price deregulation and confuses correlation and causation. No attempt is made to model what Victorian electricity or gas prices would be, had price deregulation not occurred.
- The Review uses cost build ups based on CME analysis to make conclusions on the retail component of energy bills. There are a number of issues with this analysis as it:
 - failed to analyse real retailer costs such as wholesale market risk management, line losses, customer debt and the cost of having very sizable funding lines set aside to meet AEMO 24 hour prudential requirements. Failure to quantify these costs leads to a high retail component which was regularly described by the Panel members as for ‘simply sending a bill’. Powershop notes the large differences in the retailer component in this flawed analysis and how it compares to that found by the ACCC and as described in their Retail Electricity Pricing Inquiry preliminary report; and
 - failed to examine different customer segments, most notably lower usage and solar customers, where the retailer component can vary significantly from the average customer.
- The Review failed to recognise and quantify the costs of a retailer’s main role in the electricity and gas value chain, that is, wholesale energy risk management. This is evidenced by the comparisons made of the retail component of an electricity bill to those in a water bill. These comparisons were used to drive the conclusion that the retailer component is unreasonably high in electricity. The fact that comparisons to the water industry are made suggests a fundamental misunderstanding in how the water and electricity industries operate and the differences between the two, and has led to the incorrect perception that regulation of retail electricity will not have an impact on other parts of the system, most notably generation investment.

Powershop understands the request from government to publish a reference price and the time-constraints imposed, however the methodology and the use of the reference price must be clear and understood. If implemented utilising broad-based assumptions and rules-of-thumb, due to complexity and time constraints, it will lead to an inaccurate price, leading to customer confusion, potential inequities in price setting, and a wary investment community (which will lead to reduced investment and as a outcome, higher wholesale and retail prices).

Set out below are responses and comments on the issues and questions raised in the Paper.

2. Submission

1. Commission’s proposal to adopt a cost-based approach

Cost based approach

Powershop generally agrees with the Commission in its’ proposal to broadly use a cost-based approach. However, as indicated in this Submission below, there are a number of factors the Commission must address to ensure that the reference prices meet the objectives.

Interim approach

As outlined in this Submission, Powershop is concerned that due to the time-constraints

imposed by government, the Interim Approach of utilising other non-Victorian, historical, regulatory benchmarks¹ to inform retail operating costs and retail margins will result in gross misrepresentations of current costs and margins for a retailer in Victoria. Time constraints cannot be used as a reason for inaccuracy, which will at one end of the spectrum confuse consumers, and at the other end scare investors.

Meaningful and number of reference prices

To be meaningful as a reference price, the price has to be comparable to prices actually charged by retailers to customers. Therefore it has to be by distribution area, customer type (residential v business) and tariff type. This means there will need to be a minimum of 20 reference prices for electricity (5 distribution areas x 2 customer types x 2 tariffs) and 24 reference prices for gas (at least 12 distribution zones x 2 customer types).

In addition, as wholesale energy markets move on a daily basis, reference prices will need to change daily. As a daily reference price would be impractical, at a minimum the reference price would need to change each month. So at a minimum, the regulator will need to prepare and publish 528 separate reference prices each year.

Wholesale costs – some issues to consider

1. Price Shape - New generation and behind the meter resources have come online 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, has led to a peakier market (higher proportion of peak, with a sharper, narrower peak, later in the day). This has the consequence of retailers having 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 the use of the most recent data, as proposed, is inappropriate to predict the future.
2. Price Level – Powershop generally supports utilising a rolling average view of the visible forward curve relating to Base Swaps as a proxy for spot price outcomes, as this is generally supported across the industry. 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 Calendar Year base Swap prices in November prior to the commencement of the Calendar Year against the actual wholesale spot outcomes shows the opposite. That is, for Base Swap the pool outcomes were 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

3. Load shape - The proposed approach assumes all retailers have the average of market load shape. This is clearly not the case as different retailers target different market

¹ For example iPART’s 2009 review on energy prices relates to a pre-Hazelwood NSW market and ICRC’s 2017 report relates to ACT which is dominated by an incumbent, semi-government retailer with strong corporate connections to the sole distributor.

segments. Meaning, a new entrant residential 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 with price shape, load shape is changing and will continue to change over time.

4. Load level – While we agree that at a system level, demand is forecast to be flat, at an individual customer level the situation is more complicated and volatile. A prudent retailer will assess the possibility that the forecast change in their customer usage may not match the system average, based on in home appliance usage, solar, batter & EV uptake, the price of gas, and economy wide variables.
5. Customer numbers – the proposed approach is appropriate for a market wide assessment of costs. However, in reality, retailers are either growing, stagnant or declining (including uncertainty around this) making assumptions about the level of hedging in the proposal inappropriate. There is a significant financial risk associated with customer numbers not meeting forecasts and there are significant costs in arranging appropriate hedging to manage that risk.

In summary, the situation is more complicated than the proposed approach assumes. A prudent retailer needs to manage the above factors, and therefore an allowance for these factors needs to be included over and above the cost proposed which assumes perfect foresight. This needs to be dealt with by the Commission. The mere fact that something is complicated does not mean it can be, or should be, ignored. Ignoring these factors will lead to an inaccurate price, customer confusion and a wary investment community (further leading to reduced investment and as a outcome, higher wholesale and retail prices).

Contract costs & hedging

1. Low liquidity – contract types with low liquidity in exchange trade markets (e.g. Peak Swaps) is a good indication that retailers (and other participants) are not utilising them in their portfolios. Therefore, the proposed approach should ensure that these contracts are not overly representative in any portfolio.
2. Timing and volume of hedging – different retailers opt for different hedging strategies based on their overall risk appetite, corporate/funding structure, access to physical generation, business lifecycle and strategy. There is not a ‘right’ and ‘wrong’ approach. Accordingly, some retailers progressively hedge (various timings and volumes) over an 11-12month period while others may choose to hedge entire forecast load concurrently with the time of setting customer prices. 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”.² When considering the timeframe and volumes included in the prudent retailer’s efficient portfolio, prices and volumes used should be the higher of the weighted average hedge book prior 11 months or the two months³ before setting calendar year start.
3. Efficient hedging position – the proposed approach seeks to take a view on a prudent retailer’s view on risk and therefore loss they are willing to absorb, in determining an efficient hedging portfolio. However, the risk appetite of Victorian retailers is very disperse, reflecting the different customer size, load and segments held, integrated wholesale positions, debt and equity mix and sources and additional income streams etc. Again, there is not a ‘right’ and ‘wrong’ approach. It is not clear how a reference price will cater for this variance. This needs to be dealt with by the Commission. Just because something is complicated does not mean it can be ignored.
4. Inferred Peak Swap prices – the proposed approach assumes that as there are low liquidity in Peak Swaps then the price will be inferred based on the price for Base Swaps. It should be noted that due to the low level of trades in Peak Swaps, retailers are not

² Bank of America Merrill Lynch report “Australian Utilities - The last hurrah is behind us” 11 April 2018

³ Reflecting standing offers are published on 1 December and 1 July each year.

using them as the basis of their hedging profiles. Therefore, the number of Peak Swaps used in the calculation of the prudent retailer portfolio should be very low to reflect the reality of volumes traded. That is, the portfolio should reflect the reality that a retailer faces, not a theoretical position.

Green costs

1. LGC Default calculation – the proposed approach prefers to use a “default calculation” instead of a visible forward market, due to low liquidity concerns. There has been no information outlined on how this calculation will work and ignoring market prices is concerning. Further, the visible forward market will likely be a more accurate indicator of cost compared to a model.
2. LGC & STC % – the proposed approach does not take into consideration the increasing calendar year requirements to surrender LGCs and STCs. In addition, the % to be surrendered changes annually after the start of the calendar year and after the usual annual change in retail offers. Therefore, retailer’s 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 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 ⁴
% Increase	13%	143%

Gas – netback price

Powershop is not clear that the gas wholesale netback approach is the most appropriate mechanism to calculate retailer gas costs, as this approach does not reflect the price of gas contracts offered to retailers. As a recent entrant into the gas market, Powershop is fully aware of what is generally available in the wholesale market, having explored options with most, if not all, the wholesale suppliers available in Victoria. While we cannot disclose contract pricings offered to Powershop, our experience is that netback price does not reflect the gas wholesale prices available. If the gas wholesale net back price is to be used, there are a number of issues regarding the calculation that highlight how inaccurate the netback calculation may be:

1. Export Price and Exchange rate – Pricing components need to reference forward contract prices for the periods that are being calculated. Does the proposed approach intend to use a single day or average time series to determine the exchange rate (USD/AUD) used to convert the AUD oil price?
2. Shipping (Gladstone to Japan)– the proposed approach intends to use estimates from Drewry Maritime Research of AUD ~95c/GJ in 2018. Is there any other supporting data?
3. Liquefaction and auxiliaries – what is the basis for the estimates of SRMC of liquefaction (~\$1) and Auxiliaries (9%)?
4. Transport (Wallumbilla to Gladstone) – as acknowledged by the Commission and the ACCC, the costs of the pipelines from Wallumbilla to Gladstone have been sunk. Therefore, as per the ACCC calculation they should be excluded from the netback calculation.
5. Transport (Wallumbilla to Victoria) – the proposed approach acknowledges that the transport is generally priced on a capacity reservation basis:

⁴ Non-binding STP (published previous year) was 8.06%.

- Transport generally priced on a capacity reservation basis, reflecting high fixed cost (capex) and low variable cost structure of pipelines; and
- Two customer type load factors have been considered to calculate the transportation costs. Do transport costs capture storage and capacity costs associated with managing peak loading? Will these costs be calculated separately for business customers and residential customers with different load factors?

The large number of uncertainties above, indicate that a significant allowance needs to be made for the uncertainty with any netback estimate.

Retail operating costs

Powershop agrees that the Commission’s long term approach to use a bottom up cost method is reasonable. However, 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.

Powershop understands the time-constraints imposed by Government, however the interim approach of utilising historical, regulatory benchmarks from NSW and/or the ACT to inform retail operating costs will result in gross misrepresentations of current costs for an efficient retailer in Victoria. This has the potential to lead to a reference price that does not accurately reflect real costs, leading to further customer confusion, and investor wariness.

Retail margins

Powershop agrees that the Commission’s fully comprehensive approach utilising analysis using three approaches – expected returns, bottom up, and benchmarking with comparable firms. However, without further information of the method proposed it is difficult to assess.

Powershop reiterates that the interim approach of utilising historical, regulatory benchmarks from NSW and the ACT to inform retail margins will result in gross misrepresentations of current margins for an efficient retailer in Victoria. This has the potential to lead to a reference price that does not accurately reflect real costs, leading to further customer confusion, and investor wariness.

Other costs

Powershop notes that some additional costs classified as “other” should be re-classified as per industry norms, for example:

- “wholesale costs” should include AEMO fees, RERT costs (new significant costs that have been imposed on retailers), ancilliary costs, loss factors, unaccounted for gas etc.; and
- “network costs” should include metering costs.

2. Other approaches not outlined, that the Commission should consider

N/A

3. Other Issues

Use of reference price in comparing to different retailers.

Further, there will also need to be an understanding of factors that might lead to different retailers having different relativities to the reference price. E.g. cost to serve, on a per customer basis will vary enormously by scale.

In conclusion, Powershop would like to reiterate our disappointment in the lack of opportunity provided to stakeholders to comment on the Review's analysis and conclusions. We have not found the analysis to be robust and do not believe that the analysis underpinning its conclusions would survive peer review. To this end it may be prudent for the Commission to wait and see the final report of the ACCC Retail Electricity Inquiry (Australia's primary organisation for the economic analysis of competition) which is expected to be released in June 2018. This does not change our support for the majority of the Recommendations, with the exclusion of Recommendations 1 and 2.

For the avoidance of doubt, we further state our position that retail markets and generation markets are linked. Beyond small scale, having a retail only business or a generation only business adds risk, and where risk is added, cost is added. This is evidenced by a number of recent transactions in the public domain, and by those undertaken by the MEA Group, where we have invested in (renewable) generation as a result of growing our retail business. Re-regulation of retail prices, as proposed, will in our view lead to a considerable slowdown in investment in new generation in Victoria. This in turn, will lead to higher wholesale prices, leading to higher retail prices for all customers, including those on the BSO.

We would be happy to meet to discuss our response should this be required.

Yours sincerely,



Ed McManus
Chief Executive Officer
Powershop Australia Pty Ltd & Meridian Energy Australia