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Essential Services Commission
Level 37, 2 Lonsdale Street
Melbourne VIC 3000

Via engage.vic.gov.au

Re: Victorian Default Offer to apply from 1 January 2021 – Draft decision

Simply Energy welcomes the opportunity to provide feedback on the draft decision for the Victorian Default Offer (VDO) to apply from 1 January 2021.

Simply Energy is a leading energy retailer with over 730,000 customer accounts across Victoria, New South Wales, South Australia, Queensland and Western Australia. As a leading retailer focused on continual growth and development, Simply Energy supports the development of effective regulation to facilitate competition and positive consumer outcomes in the market.

While Simply Energy understands the reasons behind the introduction of the VDO, Simply Energy does not support price regulation in competitive markets.

Simply Energy's submission addresses a number of components that make up the VDO cost stack and provides general feedback on the proposed approach for non-flat tariffs and alignment with network tariff periods, following this structure:

1. Wholesale electricity costs
2. Network costs
3. Retail operating costs and the impact of economic recession
4. Customer acquisition and retention costs
5. Retail operating margin
6. Other regulatory costs
7. General comments on the draft decision

Simply Energy considers that if any of the cost stack elements are not adequately accounted for, or the forecasting methodology and associated inputs are not carefully considered, electricity retail competition in Victoria could be severely diminished, to the long-term detriment of consumers, particularly those consumers willing to engage in the Victorian electricity market.

1. Wholesale electricity costs

Simply Energy considers that correctly accounting for wholesale electricity costs (WEC) is a critical requirement for the VDO, and therefore for positive consumer outcomes from competition in the Victorian electricity market. As the principal variable component in the VDO cost stack, it is important that the wholesale costs estimated by the modelling are fair and representative of expected market outcomes.

In the draft decision, spot prices have been scaled with only partial reference to information provided by the market. Peak Swap, and Cap prices at the least should also be included when generating future spot prices, to capture more of the information that the market has priced in.

In particular, the cap value is substantially lower in the sample price trace provided by Frontier Economics than the 40-day average price observable in the market. This results in lower spot price volatility, lower pool costs, as high price and load are generally correlated, and implies lower risk of high price events. As a result, the draft decision fails to reflect the market's appraisal of the expected likelihood of high-price and high-volume events such as those which occurred in January 2019.

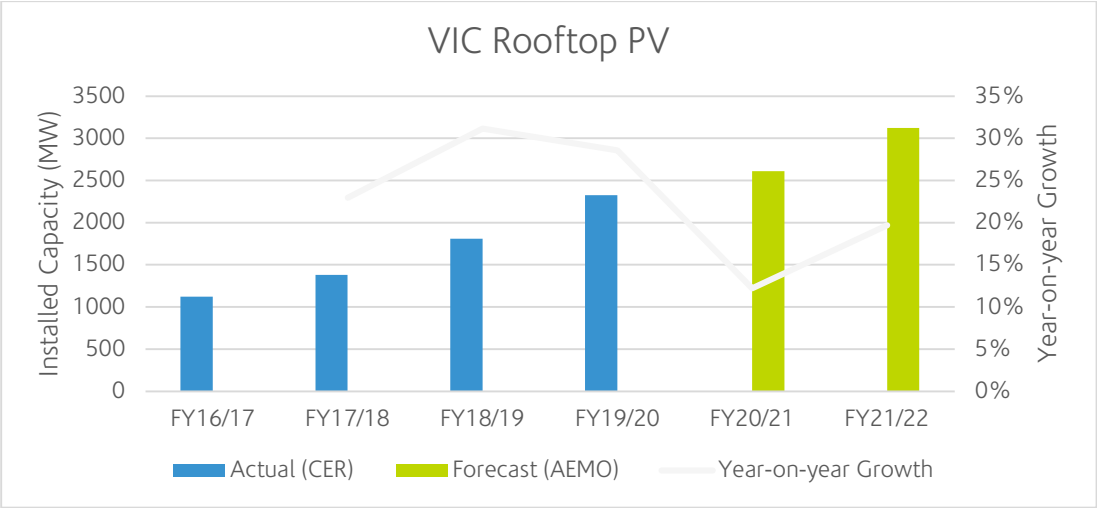
In addition, Simply Energy believes that the assumption of a contract premium should not apply to swap prices, as swaps are generally agreements between retailers and generators who both derive benefit from the resulting certainty in price outcomes. Retailers lock in price certainty (for existing load) while generators lock in revenues to meet fixed costs (for example contracting to N-1). Thus, it is not necessarily a transfer of risk from one party to another for a fee, as neither party benefits from increased exposure to the market outside their existing individual risk appetites. The removal of the 5% premium restores the pool cost by approximately the same proportion.

The draft decision modelling uses the market forward prices for contracts and spot outcomes, but these are valued differently using 365-day volume weighted averages and 40-day time weighted averages respectively. Simply Energy considers that this approach is not a fair representation of how contract traders generally forecast. While it is difficult to assess the impact in dollar terms of the difference in arbitrage assumptions, Simply Energy's view is that contract traders generally consider the use of the forward curve to provide the most accurate forecast and is useful in verifying that contracts are valued fairly.

Simply Energy considers that using load data as far back as 2016 is not representative of typical Victorian demand for 2021, as the rooftop solar PV penetration since then has dramatically increased, which has caused changes to the underlying demand profile (principally lower demand in the middle of the day). The market has tended towards increasing price volatility as the composition of energy generation moves away from baseload generation, to a composition that reflects increasing uptake of rooftop PV and changing consumption patterns.

This trend continues apace, affecting both customer load shapes and spot price behaviour. The draft decision methodology includes data from the past four years separated by weekday and weekend, then samples uniformly from these to form the next calendar year. Simply Energy agrees with the decision to keep historical price and load paired as preserving the correlation is key, but the change in this correlation over recent years precisely underscores why sampling from many years in the past leads to an inaccurate assessment of future outcomes. The result is that the simulated outcomes understate the significance of the changes that have occurred on cost outcomes for retailers. One such material change was the closure of Hazelwood power station. Prices and loads sampled from before this event are certainly not reflective of market conditions post closure.

Rooftop PV installed capacity in Victoria has experienced consistent double-digit growth in recent years that is forecast to continue (see figure below).



Sources:
CER postcode installation data[1]
AEMO rooftop PV projection, Central scenario for VIC[2]

The impact of ongoing growth in rooftop PV installed capacity should be taken into account in setting the VDO as it will continue to drive day-time demand even lower. This is likely to increase the overall wholesale cost to serve customers as the middle of the day is typically the lower price period and having less consumption during this time means there is proportionally more consumption during higher-priced periods.

Either the load data should be shortened to 1-2 years (which has its own problems, as taking weather from a single year is not ideal), or, a model to incorporate increasing rooftop PV should be used.

The current methodology sets the price based on a median wholesale cost. This largely disregards the level of risk management required in a retailer's decision making. The retailer must be able to handle outcomes far above the median and bears the corresponding costs. The present pandemic is an example of the impacts when risk becomes manifest. It changes the calculus for retailers as prices are altered and customer loads are shifted in quantity and timing, imposing costs on the retailer above those anticipated by the VDO.

The present methodology does not provide sufficient scope for a retailer to price in this risk. Use of a median represents a particular view on average expectation of cost rather than an upper bound on likely costs. In other words, there is a 50% chance by Frontier Economics' own predictions that price and load outcomes will coincide to result in higher costs than taken account by the VDO, with the consequent impact on retailers who have to bear these higher costs.

The viability of the VDO depends on its serving customers interests without damaging retailers' ability to manage risks in the market on customers behalf. A situation where retailers are provided with a 'heads' or 'tails' probability of covering their actual wholesale costs is not viable. Simply Energy would recommend the VDO is set so that the probability of loss is less than 5% meaning

[1] http://www.cleanenergyregulator.gov.au/RET/Forms-and-resources/Postcode-data-for-small-scale-installations

[2] https://aemo.com.au/-/media/files/electricity/nem/planning_and_forecasting/inputs-assumptions-methodologies/2020/2020-inputs-and-assumptions-workbook.xlsx?la=en

95% of wholesale market outcomes should be captured by the VDO. Noting that offers below the VDO may still be required to attract new customers.

2. Network costs

Simply Energy agrees with the Commission that the general cost pass-through approach to network costs is the most prudent approach to reasonably allowing for network costs in the final VDO determination.

Given that a significant portion of an electricity retail customer's bill is made up of network costs, it is imperative that the latest data be used when determining the VDO. If actual data is not available, then network cost forecasts should be developed using a transparent approach that includes an allowance for the risk that actual costs exceed the forecast. If a risk allowance is not provided, then the retail margin needs to be increased to take account of this risk, which was not borne by the businesses the benchmarks relate to.

3. Retail operating costs and the impact of economic recession

The benchmark used for the draft decision on retail operating costs is now 7 years old and should be updated, using a process that is transparent to stakeholders, to ensure it reflects current costs incurred by retailers in serving Victorian customers.

A critical retail operating cost that needs to be forecast as part of the 2021 VDO is bad debt expense from customer bills that are unpaid. Bad debt expense is an existing cost that retailers bear, and Simply Energy's experience is that this has remained within a narrow range (as a percentage of revenue) in recent years, with unemployment also in a narrow range at approximately 5%.

Unemployment during the current recession is forecast to increase to approximately 8% during 2021, and government financial support and mortgage holidays provided by banks are ending in early 2021. Taken together, reductions in financial support for people impacted by the recession, and increasing numbers of people impacted by it, are expected to put pressure on energy customers, which will see an increase in the bad debt expense carried by retailers (as a percentage of revenue). Simply Energy's assessment is that an increase in unemployment from 5% to 8% will see a commensurate increase in retailer bad debt expense of approximately 50%. For example, a bad debt expense of 3% of revenue with 5% unemployment will become a bad debt expense of 4.5% of revenue with 8% unemployment. Forecasts of the impact of the recession on households and small businesses, from private and government sources, is available and the Commission should make use of it when forecasting retailer bad debt expense as part of the VDO for 2021.

4. Customer acquisition and retention costs (CARC)

Simply Energy has seen a marked increase in these costs since 1 July 2019 and the CARC provision in the cost stack does not represent the costs retailers face in Victoria. The benchmark should be set using a process that is transparent to stakeholders, to ensure it reflects actual costs incurred by retailers in serving Victorian customers.

5. Retail operating margin

To be credible, price regulation in Victoria must reflect the costs that retailers in Victoria face. To use benchmarking and regulatory decisions from other jurisdictions creates unnecessary risk to retailers in Victoria and Simply Energy considers that a different approach is needed.

The benchmark should be set using a process that is transparent to stakeholders, to ensure it reflects the actual situation faced by Victorian retailers. This is vital to ensure new entrants and retailers without generation assets are not unduly constrained.

6. Other regulatory costs

The licence fee cost estimate for 2021 should reflect the Essential Services Commission licence fees set by the Minister in late 2020, to ensure the latest information is used.

7. General comments on the draft decision

While the approach to non-flat tariffs improved from the draft to the final decisions for the 2020 VDO, Simply Energy still considers that the approach used by the Australian Energy Regulator for non-flat Default Market Offer tariffs is superior and should be adopted by the Commission.

The draft decision includes a 12-month regulatory period from 1 January 2021. Two sets of network tariffs will apply during this period, with new network tariffs in place from 1 July 2021. The tariffs that will apply from 1 July 2021 will not be available at the time the VDO for 2021 is set, and the criteria for reopening the VDO in mid 2021 to take account of network tariff changes are unlikely to be met, as any credible movement in network tariffs will not have a material impact on customer bills. However, credible movements would have a material impact on retail margins and should be taken account in the VDO's forecast of network tariffs to apply from 1 July 2021.

While a 12-month VDO from 1 January 2021 is preferable to an 18-month VDO from 1 January 2021, Simply Energy continues to support a 6-month VDO from 1 January 2021, followed by a 12-month VDO from 1 July 2021. This will have two key benefits: there will be more up to date information available about the network tariffs to apply from 1 July 2021, and more information about the impacts of the economic recession on customers and their ability to pay their energy bills, once government support and mortgage holidays provided to impacted people has begun to be wound back.

Concluding remarks

In closing, Simply Energy looks forward to continuing to work actively with the Commission to ensure the inputs and methodology for setting the VDO accurately reflect the Victorian electricity retail market.

Simply Energy welcomes further discussion in relation to this submission. To arrange a discussion or if you have any questions please contact Aakash Sembey, Manager, Retail Regulation, at aakash.sembey@simplyenergy.com.au

Yours sincerely

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