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Victorian Default Offer to apply from 1 January 2021

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 (VDO) to apply from 1 January 2021 Consultation Paper (the Paper).

Background on the MEA Group

The MEA Group is a vertically integrated generator and retailer focused entirely on renewable generation. Through our investment in new generation, we have continued to support Australia's transition to renewable energy.

Powershop is an innovative retailer committed to providing lower prices for customers and recognises the benefits to customers in transitioning to a more distributed and renewable-based energy system. Powershop has introduced numerous new, innovative, and customer-centric initiatives into the market.

MEA Group supports the robust consultation process and review period applied to this Paper, allowing for 2 months of deliberation before a draft decision is provided. However, we do not support the position the ESC holds regarding the methods adopted for previous VDOs;

"*We consider that the methods used to estimate most cost items remain appropriate as we recently concluded the 2020 VDO process in November 2019. We would need to have strong new evidence to change our approach for most cost items*"[1].

MEA Group considers that not reviewing the methods used to estimate cost items will continue to embed systematic errors into the calculation of the VDO. All methods should be continuously assessed and reviewed on an annual basis to ensure that the continue to be as accurate and reflective as possible. In addition, the methods used to estimate most cost items were decided upon before the COVID-19 pandemic. To achieve the most accurate VDO determination, the ESC must account for the recent and ongoing changes to a retailers' cost of supplying electricity to Victorians. These costs are highlighted throughout this submission and include wholesale costs and increases related to debt.

MEA Group believes the pandemic will materially impact cost items such as wholesale, network, environmental, retail operating costs, customer acquisition and retention costs and retail margins and the methods used to estimate these costs must be reviewed to ensure that the stress on the cost structures relating to the pandemic is reflected in the results. Retailers now, more than ever, are being asked to shoulder significant credit risk, of the entire energy value chain, through increases to bad and doubtful debt and provide increased support and assistance to our customers and the Victorian public through the pandemic and beyond. The change in the risk profile of retailers across the industry must be reflected in the next VDO determination.

[1] Essential Services Commission Victoria, Victorian Default Offer 2021, Consultation paper, Page 6

MEA Group would urge the ESC to consider a change in the methods applied to estimate costs, with extra attention given to the increases in bad and doubtful debt. To assume that nothing has changed could result in an inaccurate estimation of the underlying costs of providing electricity impact the retail electricity market negatively and worsen outcomes for consumers.

The industry has been open, flexible, and efficient in its support of customers who have been impacted by the pandemic. MEA Group suggest that the VDO should also be flexible and adaptable to changing market conditions. MEA Group believes this consultation period is the ideal opportunity to, not only review cost methodologies, but to ensure the VDO is a true reflection of the relevant costs, in order to support retailers and ultimately customers in providing a fair and reasonable price.

Please find below our responses to the questions raised in the Paper.

Wholesale Costs

1. Are there any changes or issues we need to consider in relation to the underlying data we use to calculate wholesale electricity costs? In particular, changes to volume or patterns of consumption due to COVID-19 that might extend into the 2021 calendar year?

COVID-19 Pandemic

The below feedback is in accordance with, and an extension of, feedback submitted to the ESC's draft decision, dated 17 October 2019.

MEA Group are disappointed to see that the proposal does not fully take account of the drastic changes in the energy market in light of the COVID-19 pandemic. Such an event fundamentally changes consumer behaviour, exposing retailers to risks far beyond what is covered in the scope of the wholesale electricity cost (WEC) forecasting conducted on behalf of the ESC. Whilst a rare event in isolation, the pandemic is one of many 'unforeseen' events which can impact a retailer's ability to earn a fair risk-adjusted return and which is required and expected by customers to be managed and shielded from.

MEA Group, AEMO and other participants have observed material changes in load shapes, higher residential customer loads and lower small business customer loads during the pandemic. The extent to which this will continue is unknown and relationships may change in response to restrictions on movement, economic impacts, and seasonal factors. Undoubtedly, the pandemic will continue to have an impact during both the pricing assessment period and the pricing period (calendar year 2021) itself. Pandemic related changes can easily leave retailers significantly exposed and over or under-hedged.

Retailers generally hedge on the assumption that customers will use an 'average' amount of energy. The COVID-19 pandemic has highlighted how quickly historical trends in demand can break down and how quickly market prices can reflect these changes. Inevitably, if demand in the National Electricity Market (NEM) fundamentally decreases, there is a corresponding decrease in price, whilst retailers find themselves long to the market prices. The same is true in the opposite direction, where a shift in position is generally accompanied by a reverse price movement.

The simulations carried out by Frontier Economics in the determination of the WEC are carried out on a static annual volume basis, with each simulation being scaled to 1000 MWh. The consumer behaviour response to the pandemic shows this to be unrealistic. MEA Group believe that there are a multitude of plausible events which could see wholesale costs increasing far beyond those conveyed by the existing VDO WEC methodology.

Hedging approach

MEA Group firmly believes that the modelling approach has some foundational flaws, grossly understating the risk horizon faced by retailers. This is a view which has been previously conveyed and raised by other retailers. The modelling methodology of linking price and demand through the 'bootstrap resampling method' does not adequately reflect the significant exposure to high demand events with simultaneous high prices. As the supply side of the market continues to become more exposed to extreme events, the current methodology does not consider the high costs that would be incurred if consumer demand exceeds the actual events within the VDO historical analysis period.

High demand events, such as those seen in 2014, grossly exceed the demands observed over the past few years upon which the VDO wholesale cost stack is built. Based on the current supply and the closure of Hazelwood power station, MEA Group expects that if historic high demands eventuated today then extreme high prices would inevitably occur. As demand and price are linked in the bootstrap resampling method, even an infinite number of simulations would never yield an outcome worse than the costliest period in the lookback period.

MEA Group again reiterates 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"[2]. Whilst the Frontier Economics approach moves away from hedging these extremes due to assumed low pay offs, retailers may not in a position, or have the working capital, to adequately handle large swings in cash flow and as such chose to hedge extremes to a higher degree. MEA Group asks the ESC to be conscious of the fact that retailers will seek to further protect themselves against extreme prices due to other cash flow implications arising from the COVID-19 pandemic.

MEA Group continues to support the reference of futures prices in determination of the WEC. MEA Group does however have concerns over the window of dates used in the determination of the 12 month trade-weighted price. The inclusion of the Cal-21 ASX option expiry date in November would allow for the use of option contracts for hedging purposes and will include more of the volume of traded products. Option contracts allow retailers to better manage price risk and uncertainty in customer numbers and are an important element of many retailers hedging approach. They may become used to an even greater extent because of pandemic-related uncertainty.

Additionally, the use of a 12 month trade-weighted methodology requires retailers to have perfect foresight over what volumes will trade on a daily basis during the period. It is unrealistic to expect retailers to be able to conform to this to a high degree of accuracy. The ESC should consider the extent to which a retailer's hedge costs may differ to the simulated hedge costs even with the best endeavours of the retailer to enter contracts on a trade volume-weighted basis. Trade volumes have a reasonable degree of variability both inter- and intra-year and retailers using best endeavours to hedge on a trade-volume weight basis will always find their hedge costs different to those presented in the VDO.

Solar

The continued uptake of rooftop solar PV is having significant impacts on load profiles and therefore wholesale costs. Solar PV is reducing the average energy usage across a portfolio of customers whilst morning and evening peak demands remain high. This increase in peak to average ratio leads to higher costs on a unit basis.

MEA group believe that continued future uptake of solar PV needs to be included in the scenario analysis conducted by Frontier Economics. Failure to do so will likely underestimate the net usage costs faced by retailers during the 2021 VDO period. As there is some uncertainty in the rate of uptake, MEA Group suggest inclusion of a fixed shape premium in the absence of any conclusive modelling.

Back-testing of methodology

In calculating and determining the WEC component of the 1 January 2021 VDO, the ESC should back test the model against historical outcomes and identify the magnitude of deviations against the predicted costs. The method applied by Frontier Economics needs to be tested against the disaggregated, real data to ensure that the WEC calculated do not systematically understate costs retailers incur. To apply an inaccurate WEC will ultimately lead to inefficiencies in the market.

Retail Operating Costs

3. What impact has COVID-19 had on retail operating costs and for how long will it effect costs?

MEA Group recommends that the ESC adjust the methodology in estimating retail operating costs for the VDO. To base the methodology on an ICRC paper from 2017, which itself references an IPART methodology undertaken in 2013 is not appropriate at this time. MEA Group recommend that the ESC work to review the methodology and apply it to the current Victorian retail electricity market. The macroeconomic impacts of the pandemic are broadly replicated into the energy retail market.

Another concerning factor that may impact retail operating costs will be the impact of pandemic-related government subsidies (including the JobKeeper and JobSeeker payments) potentially concluding in September 2020. Many Victorian electricity customers have been impacted by the pandemic situation, including reductions in both their income and their ability to pay for the energy they consume and changes to the government schemes will continue to impact Victorians.

The current pandemic situation has impacted the industry's ability to mitigate credit risk. COVID-19's impact on the shift in the doubtful debts provision has been compelling. Key quantitative data and insight have been provided as a confidential attachment to our submission. With the Federal Government citing an effective unemployment rate in the low teens, MEA Group believes that how the government manages the level of income support provided by the JobKeeper and JobSeeker payments, and the consumer response to any changes, will be crucial to the management of retailers debt books. As one example of this, our analysis indicates that many of MEA Group's

[2] MEA Group, submission to the Victorian Default Offer to apply from 1 January 2020 Draft Decision, Page 3

customers on long term assistance plans (our data suggests a majority are in receipt of Government benefits) have been repaying their debt at a higher rate since the introduction of increased income support, to ensure it does not get out of control. There are the major factors which are likely to contribute to further delinquencies over the coming months that MEA Group believe requires strong consideration:

a) Higher energy bills from the winter months;

b) Continuation of pandemic containment measures leading to higher residential energy loads;

c) Projected declines in household income resulting from a poor economic outlook; and

d) Possible scaling back of government stimulus packages.

Flat VDO Tariffs

5. Are there other options for setting non-flat tariffs that would fulfil the objective of the VDO?

6. Are there alternative approaches to allocating per day and per kilowatt hour charges that would better suit the objective of the VDO?

7. Are there any other matters we should consider when allocating fixed and variable costs?

Whilst MEA Group acknowledges the ESC will continue to apply the network cost pass through approach for the 2021 VDO price review, a critical review into this method is required. Retailers should be entitled to a cost recovery that expands beyond the flat tariff only. Alternatively, the ESC, through regulatory intervention, could require the relevant network to accept a retailer's tariff change request. This will reduce the risk of unmatched retail tariffs and network tariffs.

Maximum Bill

8. What other options should we consider for regulating non-flat standing offer tariffs and why?

MEA Group still hold concerns regarding the impact that the maximum bill amount has on reduced efficiency, price signal distortion (peak and off-peak) and negatively impacted customer demand. MEA Group believes the alternative solution for the maximum bill is for the ESC to engage and research all relevant costs (e.g. varying metering and wholesale costs) that are applied to providing non-flat tariffs and provide us with a robust and well informed peak, shoulder and off peak rate.

Length of the regulatory period

12. Should the commission change the length of the regulatory period beginning 1 January 2021 to 6 or 18 months? If so, what are the reasons for why we should make this change?

MEA Group prefers that the ESC sets a 6 month regulatory period from 1 January 2021 to 30 June 2021, with a subsequent 12 month regulatory period from 1 July 2021. MEA Group supports the shift in network annual pricing to move to 1 July to reduce complexity across different jurisdictions. The VDO should accommodate that price change accordingly to correctly reflect the market prices, particularly if they benefit customers. MEA Group believe that a 6 month regulatory period would allow the ESC to more accurately reflect changes in the underlying costs faced by Victorian electricity retailers. This is especially important given the current pandemic situation and the downstream impacts.

MEA Group acknowledges the importance of ensuring a fair VDO for both engaged and disengaged customers. However, the VDO should not impact a retailer's ability to operate in the Victorian market, to continue to support our customers and to continue to provide new and improved products and services. The determination of the VDO, including the estimation of costs, should still encourage retailers to continue to compete, providing consumers with choice and the ability to engage. The VDO must allow retailers the opportunity to continue to innovate, while accurately reflecting the costs that retailers face at that time.

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

Yours sincerely,

Jason Stein
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Meridian Energy Australia