Essential Services Commission
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Lodged by email: retailenergyreview@esc.vic.gov.au

12 August 2019

Victorian Default Offer to apply from 1 January 2020: Issues Paper

The Australian Energy Council (the **'AEC'**) welcomes the opportunity to make a submission regarding the Essential Services Commission's (**'ESC'**) Issues Paper (the **'Issues Paper'**) considering the Victorian Default Offer (**'VDO'**) that is intended to be implemented on 1 January 2020.

The AEC is the industry body representing 23 electricity and downstream natural gas businesses operating in the competitive wholesale and retail energy markets. These businesses collectively generate the overwhelming majority of electricity in Australia and sell gas and electricity to over 10 million homes and businesses.

Given the position of the AEC as a representative of competitor businesses, we operate in strict compliance with the Competition and Consumer Act (the 'CCA'). The CCA prohibits the AEC discussing with members confidential information relating to costs and how they set their prices. This submission has been drafted in line with our CCA obligations, and will focus on best practice price regulation methodologies, rather than the preferred methodologies of individual members. Our members will provide more detailed views on the issues raised.

The AEC does not consider that the ESC's proposed methodology for setting the 2020 VDO is in line with best practice. During the ESC's consultation on the 2019 VDO, the AEC engaged KPMG to evaluate the Draft Advice, and identify elements of the draft advice that could be improved.[1] Whilst the AEC was pleased to see the ESC's final advice better reflect the costs of running a retail business, we are concerned that the ESC's initial position in the issues paper does not appear to reflect an evolving approach to estimating cost components from the first VDO.

Of particular concern are the retention of wholesale cost models that lack transparency, continuing to determine environmental costs without considering the practical realities of an efficient and prudent retailer, and the impacts of tariff setting on retailer costs.

The AEC understands the ESC again faces a tight timeline, however given this VDO will apply for a full 12 month period, with a broader scope than the 2019 VDO, industry is concerned that the ESC are considering a price setting approach that might disadvantage a retailer acting prudently.

Wholesale electricity costs

The ESC plans to maintain its previous approach to estimating wholesale electricity costs, appearing to rely solely on Frontier Economics proprietary STRIKE portfolio optimisation model and Monte Carlo modelling. As noted by KPMG, "It is not consistent with regulatory best practice to rely so heavily an opaque and non-

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[1] KPMG, Evaluation of ESC draft advice on the Victorian Default Offer, May 2019

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replicable methodology, which cannot be readily scrutinised by other stakeholders."[2] Given this, we would encourage the ESC to undertake additional assessments, utilising alternative approaches to Frontier's "black box" approach. Undertaking an alternative, more readily accepted and transparent approach would provide industry confidence that Frontier's result is a reasonable estimate of accepted costs.

The AEC supports the ESC's approach to utilise residential and small business load profiles separately, and to continue to provide a volatility allowance. Naturally, the most recent data should be utilised to provide a realistic assessment of a retailers current costs.

Environmental costs

The AEC does not agree with the ESC's initial position to continue to utilise a current market price based approach for estimating LRET costs. As noted by KPMG, this approach is unlikely to reflect the true costs of the scheme for a prudent efficient retailer given the rapidly falling price of LGC's.

> *"This fall, and expected future fall, in LGC prices is important because many prudent retailers have secured LGCs over several years – when the cost and spot price of LGCs was higher than it is now. That is, prudent retailers are likely to have a portfolio cost of LGCs which is above the current (or recent) LGC spot price. In adopting a 40 day average of spot LGC prices, retailers who have acted prudently in securing longer term contracts for LGCs will not be able to recover costs under the VDO. This problem is likely to exacerbate as we get nearer to the 2020 target, and the discrepancy between the portfolio cost and market price grows."* [3]

We strongly encourage the ESC to undertake an assessment of the portfolio, or contract, cost of LGC's for a prudent retailer.

We are comfortable with the ESC's proposed approach for estimating SRES costs, noting that a retailer's actual obligation cannot be known until March 31 2020. This creates a situation where the ESC either has to make an amendment in the VDO, or allow for a risk margin if the estimated obligation is materially incorrect. The AEC does not consider it would be practical (nor beneficial for customers) to amend the VDO unless the impact of the recalculation is substantial.[4] Given this, we would encourage the ESC to consider an 'unders and overs' approach in the following regulatory period if actual costs differ from the allowed costs. This would require the ESC to undertake a reconciliation in future years to allow retailers to recover efficient costs in the longer term.

Network costs

The AEC considers the ESC may need to undertake a more thorough analysis of the impact of network costs on retailers, depending on the tariff structures determined for the 2020 VDO. Whilst in 2019 it made sense to reflect only flat tariff costs in the VDO, in 2020, when all tariff types will be included, this may not remain reasonable. This issue is discussed further below.

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[2] Ibid, Pg 11
[3] Ibid, Pg 16
[4] An amended VDO would have flow on impacts to other obligations, including the use of the VDO as a reference price. The likely costs for an out of cycle amendment would likely be significant, and should not be considered lightly.

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Calculating the VDO

In 2020, the ESC has been tasked with setting a flat VDO, a flat and controlled load VDO, and a non-flat VDO. With respect to the first two VDO's, the AEC supports the ESC's intention to set the tariff in the same manner as in the 2019 VDO.

The non-flat VDO is more complicated, and requires the ESC to make a number of interpretations as to what the Government intended in the section 13 Order in Council (**'the Order')**. Clause 10(2)(a)ii requires the ESC to determine the maximum annual electricity bill (the **'maximum bill'**) amount that a customer is required to pay on a standing offer. Clause 12(5) states that the maximum bill must be based on the flat tariff, and the customer's usage.

The issues paper sets out two potential approaches for setting the maximum bill. Approach 1 appears similar to the approach utilised by the Australian Energy Regulator in setting the Default Market Offer (the **'DMO'**). In this approach, the ESC could set a maximum bill utilising a model consumption profile. The retailer would then be able to set its tariff components as it wished, provided the annual bill for a representative customer equalled the maximum bill. For all other customers, their bill outcomes would vary.

Approach 2 appears unique in regulatory price setting. It infers that the maximum bill would be set for each level of consumption, in a flat manner, with the retailer prohibited from charging a customer more than the maximum bill, irrespective of their total consumption or usage pattern. In effect, and as noted by the ESC, this would likely result in retailers setting all tariff components at the flat tariff rate. Given this, if approach 2 was utilised, the AEC see no benefit in the ESC setting a maximum bill at all, instead preferring a prohibition on non-flat VDOs. In either case, the AEC would expect the ESC to identify - and make allowance for - the network cost risk an efficient retailer would be unable to avoid.

The AEC's preference is to align the non-flat VDO to the AER's DMO approach. This would require the ESC to determine a model usage profile, and allow retailers to set a tariff that met the maximum bill for the model customer. The model profile should deliver a maximum bill identical to what a flat tariff VDO customer would pay if they consumed the model usage.

Alternatively, the AEC would support the ESC setting a time of use VDO tariff, in the same manner as it sets the flat VDO tariff. Retailers would no longer be 'price setters' with regard to the VDO, and this approach might better reflect the Governments stated intention of an independently set, fair price for all consumers.

The AEC would welcome the opportunity to discuss this submission further, and looks forward to ongoing engagement with the ESC as it undertakes this critical task. Failure to adequately compensate retailers for their efficient costs risks irreversibly damaging the retail market, and significantly impacting the experiences of Victorian consumers. For any questions about our submission please contact me by email at ben.barnes@energycouncil.com.au or on (03) 9205 3115.

Yours sincerely,

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