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Department of Environment, Land, Water and Planning (DELWP)

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Dear DELWP

Implementing the Victorian Default Offer – Meridian and Powershop response to the draft Orders
Consultation paper

Meridian Energy Australia Pty Ltd and Powershop Australia Pty Ltd (MEA Group or Powershop) thank the Department of Environment, Land, Water and Planning (DELWP) for the opportunity to provide comments on the Victorian Default Offer – Draft Orders consultation paper (the Paper) to implement the Victorian Default Offer (VDO) to apply from 1 July 2019 .

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 and in early 2018 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 a number of significant, 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 customer-led demand response program.

The MEA Group believes the draft Order in Council (OIC) will not achieve the objective of improving customer outcomes.

As per our submission to the Essential Services Commission Victoria (ESC) draft advice on 4 April 2019, the MEA Group 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 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 customer outcomes.

The MEA Group would support Victoria adopting the Federal government's Default Market Offer (DMO) in place of the VDO. This approach was recommended in an economic analysis report released by Craig Emerson Economics which "recommended that the ESC and the Victorian Government delay consideration of the VDO and work with the Commonwealth on the design and implementation of the DMO".¹

The Emerson report also advised that the VDO will eliminate basic levels of retail profit, leading to retailers leaving the market and preventing new entrants, which as a consequence would stifle innovation.

The proposed Order in Council (OIC) introduces numerous issues which are likely to be detrimental to customers as reflected above. In particular, we believe that a number of technical and practical complications arise primarily as there has been insufficient time for appropriate consultation with industry and stakeholders. For example, we refer to draft clause 14 (default offer prices to be the reference price for discounts) which was always understood to be implemented by the ESC as part of the Thwaites review response. This consultation process is the first opportunity for industry to fully consult on this issue. Without the usual two-stage transparent and robust consultation process there is likely to be issues missed and unintended consequences borne by customers.

Due to this very narrow consultation period, we support the submission provided by the Australian Energy Council (AEC) to apply a stepped implementation process to comply with the OIC by 1 January 2020. This would allow all participants to implement the OIC requirements in a more measured and appropriate manner and ensure best outcomes are achieved for customers.

We provide our responses to the questions raised in the Paper below.

1. Is the objective in clause 3 of the draft section 13 Order clear and appropriate?

The VDO needs to ensure it only impacts customers that are either unable or unwilling, to engage with the market and are on standing offers. The MEA Group provided in its submission to the ESC's draft advice that this objective needs to appropriately consider the competitive market in accordance with Section 8A of the *Essential Services Commission Act 2001*. To fully achieve the objective set by the Independent review and consistent with the government's stated policy objectives in the VDO terms of reference provided to the ESC, the MEA Group believes clause 3 should reference the competitive market consistent with the ESC draft advice that the VDO operate 'without impeding the customer benefits experienced by those who are active in the market'.²

2. Does clause 6 of the draft section 13 Order adequately give effect to the VDO for the initial period from 1 July 2019 to 31 December 2019?

The MEA Group is concerned that the Government has determined to fix a price for all standing offers and not a cap as advised by the ESC. This may have a number of consequential effects, including that it may no longer be permissible to discount standing offers (requiring customer engagement to sign up to a market offer) and retailers may be prohibited from providing similar discounts to hardship customers. If the ESC advice was premised on standing offers below the price cap not increasing, this advice may now be invalid.

The ESC has acknowledged that it does not expect retailers to increase standing offers to match the VDO. If there is strict adherence to applying the VDO price, customers that currently enjoy discounts off standing offers below the VDO price will see them disappear from 1 July 2019. Consequently, the VDO price will unintentionally impact some customers who were unwilling to engage the competitive market but will now have to.

The MEA Group believes the OIC should be adjusted to only apply to those customers who are above the VDO price, and remove the unintended consequence of affecting all customers below it.

3. Does clause 9 of the draft section 13 Order appropriately reflect the objective of the VDO?

This clause should be made subject to the same consultation process referred above for clause 14. The MEA Group believes that the 42 day requirement for the ESC to determine prices may not be enough time for the ESC to assess the impact of changes to network costs and tariff data on the relevant VDO prices before the start of the regulatory period. We know that under the Commonwealth Draft Code (subject to determination from the AER) the AER will set the Default Market Offer (DMO) prices 56 days in advance of the new regulatory period.

¹ Craig Emerson Economics, Economic consequences of the Victorian Default Offer, April 2019, Page 1

² Essential Services Commission, Victorian Default Offer to apply from 1 July 2019 – Draft advice, 8 March 2019, page 6.

As the Emerson report highlights, price determination for Victorian customers can be achieved under the DMO process, providing improved consistency, efficiencies and centralised price determination across the NEM.

Another solution is to remove the gazettal requirement entirely. However, if this clause remains the MEA Group proposes to keep the 42 day requirement but reduce the current mandatory gazettal period of 30 days down to approximately 14 days. This will provide the ESC more time to incorporate relevant changed network tariffs and give retailers time to prepare, produce and arrange relevant gazettal notices.

4. What would be the implications of the alternative option – the VDO continuing to be a flat tariff (or flat tariff with controlled load tariff) only?

There are broader requirements that have not been considered in the design of the VDO. There are obligations for networks to continually develop and implement tools that act as price signals to the market.³ Non-flat network tariffs are tools that effectively provide this mechanism.

With flat VDO tariff prices there are no price signals provided to customers to reduce their peak loads. Advice will need to be provided to affected customers that ensure they do not apply assumptions and comparisons of the flat VDO prices to the varied non-flat tariffs that the networks will apply. With the obligation on the network to provide flat and non-flat tariffs, the MEA Group believes the VDO should also cater for such current tariff types.

5. Does the approach and methodology specified in clause 11 of the draft section 13 Order appropriately reflect the objective of the VDO?

The MEA Group proposes amendments to clauses 11(7) and 11(8) of the OIC to insert the words ‘prohibit or’ before ‘require the Commission’, providing the opportunity for the ESC to consider a retailer’s actual costs and operating margins, as required under the ESC Act.

The ESC has not yet addressed clause 11(2) by confirming the approach and methodology it intends to undertake to best meet the objective of the VDO. MEA suggests appropriate industry consultation must occur prior to confirmation of this approach and methodology.

The MEA Group also notes that this clause has removed the operation of clauses 33(3) (c) and 33(4) of the ESC Act. We understand that this is the Government’s position, but we do not agree that it is in the customer’s interests, that this change will proceed, even if ‘*the expected costs of the proposed regulation do not exceed the expected benefits*’⁴ and that the ESC should not in its ‘*determination take into account...any trade-offs between costs and service standards*’.⁵ The ESC should explain why these clauses are no longer required without an effective regulatory substitute. Customers are entitled to and should expect to receive this information which is clearly relevant to the provision of this essential service, to ensure they do not pay more than they should.

The MEA Group believes the ESC cannot deliver on clause 11(3) for VDO pricing determinations to be based on the efficient costs of a retailer if the clause fails to capture all compulsory costs that a retailer will incur as part of doing business “based on the efficient cost to run a retail business”.⁶ The MEA Group believes this clause cannot have effect until all material and ongoing costs incurred by a retailer are incorporated.

Our submission to the ESC draft advice was consistent with numerous submissions available on the ESC website supporting our view on costs. The AEC commissioned a report completed by KPMG as part of its submission to the ESC draft advice. The report evaluated the VDO cost estimates and consistent with industry submissions concluded that the approach to estimating the cost stack failed regulatory best practice for setting regulated prices: “the methodologies employed are not consistently transparent, replicable, well accepted or representative of efficient costs faced by retailers in Victoria”.⁷

Specific criticisms of the cost stack include the twelve month hedging strategy and its limitations of capturing current and future volatility in Victorian wholesale prices, utilising MRIM data from large business customers ineligible to the VDO, and using a 40 day price estimation of LGC contracts and purchases when a prudent efficient retailer enters into longer term contracts to hedge its risks.

³ National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014, AEMC 27 November 2014

⁴ Clause 33(4)(a) ESCV Act 2001

⁵ Clause 33(4)(b) ESCV Act 2001

⁶ Essential Services Commission Victorian Default Offer to apply from 1 July 2019, Preface, page iii

⁷ KPMG, A report to the Australian Energy Council, April 2019, Page 8

The Emerson report also found that if the VDO adopts the current cost stack methodology in the draft advice (to seek the lowest possible VDO), engaged customers, particularly vulnerable customers will incur significant cross-subsidisation risk. To avoid this risk, the report advises a more conservative inclusion of costs should be adopted in order to allow current and newly engaged customers access to widely available competitive and innovative offers and products.

The MEA Group believes adopting the DMO's concept of headroom cross-subsidies in a retailer's cost stack is more appropriate. The VDO excluded headroom believing it represented "excess returns (or profits)"⁸ even though the VDO has not defined this. The Emerson report advises that headroom "is a component of the price that attracts new entrants into a market".⁹ The MEA Group agrees with this view, and further supports Emerson's view that a competitive market should be able to earn a normal profit. A normal profit is one that motivates participants to remain in the market and attract new entrants.

By excluding headroom from the VDO, the ESC potentially shuts down competition, despite advice that "governments should not seek to reduce or eliminate normal profits, since these are essential to the functioning of an efficient market".¹⁰

A further conservative step inclusive of costs is to allow for innovation as part of the customer acquisition and retention costs (CARC). The current VDO locks out innovation as part of the CARC. Submissions to the ESC draft advice advised that a tier two / three retailer regularly allocates time, money and resources to provide customers with products and offers that differ from the larger retailers in order to compete beyond price. Without innovation included in the OIC, the costs that engaged and vulnerable price sensitive customers incur will be higher under the proposed VDO. We also note that innovation has become necessary to cater for various tariff structures that have developed such as the network tariffs referred to above.

Based on the above criticisms, if the VDO does not adopt the DMO, then the MEA Group encourages the Minister and the ESC to undertake a more robust consultation and implementation process, with this clause to come into effect 1 January 2020.

7. Will this approach assist customers to access the VDO? Or would it be preferable to prescribe the wording on bills and if so, what should this wording be?

The OIC fails to define what a 'prescribed customer' is under clause 7(1). The MEA Group would like the definition of a prescribed customer to match only those customers that are unable or unwilling to engage with the retail market and are on a standing offer above the VDO.

The MEA Group believes that referencing a customer's ability to access the VDO on a bill under clause 7(2) is warranted or beneficial only to those customers we have suggested should be prescribed customers under clause 7.1. Morgan Stanley Australia supports this view. Their recent analysis of the Victorian energy market found that the "default offer would probably end up confusing customers, making them more likely to give up hunting for a better deal... Default market offer bill notifications are likely to be confusing, leading to customer inertia in our view".¹¹

A retailer will be required to advertise their 'best offer' on each bill from 1 July 2019. Asking a customer to make the distinction between their offer relative to the bill, a potential 'best offer' and then also investigate the VDO will not achieve simplicity for the customer, indeed the opposite may occur. Only when the 'best offer' outcome for a customer is the VDO should this advice about the VDO be provided.

9. Will the approach proposed in clauses 14 and 15 adequately meet the Government's intention to enable discounted offers to be easily compared?

The MEA Group believes clause 14(2) should be amended to remove the word 'benefit'. In a meeting with DELWP chaired by the AEC on 16 April 2019, this reference was acknowledged as an unintended overreach. The clause should refer to 'discount' only.

⁸ Essential Services Commission Victorian Default Offer to apply from 1 July 2019, Page 11

⁹ Craig Emerson Economics, Economic consequences of the Victorian Default Offer, April 2019, Page 3

¹⁰ Craig Emerson Economics, Economic consequences of the Victorian Default Offer, April 2019, Page 4

¹¹ Herald Sun, Power to the big retailers, John Dagge, Melbourne, 23 April 2019, Page 44

The MEA Group has provided feedback to this question above. To reiterate, introducing this clause 14 formally in April for a 1 July introduction, with no prior formal discussions with our industry, cannot be considered appropriate. Consistent with our comments above, further industry consultation is required with a target date of 1 January 2020 for implementation.

Clause 15 focuses on the amendments required to the Energy Retail Code (the Code) to implement clause 14. Consistent with our comments on clause 14, the MEA Group does not believe that the required consultation process with industry has occurred to ensure that compliance to the Code can be met from 1 July 2019. A target date of compliance with the Code by 1 January 2020 should be applied, allowing time for further consultation and discussion of consequences.

11. Is the proposed review period and approach appropriate?

As stated above, the consultation and review periods have not been appropriate for the OIC, affecting clauses 3, 6, 7(2), 9, 11, 14 and 15.

The MEA Group believes that the VDO will lead to a reduced number of retailers in the Victorian market. As Morgan Stanley advises “wholesale electricity prices were tracking higher, which was reducing the space for discounting among stand-alone retailers which do not generate their own power. We think retail energy competition will decline this year, on reducing discounts and customer retention... (This is a net positive for AGL Energy and Origin Energy)”.¹²

There is a large proportion of customers currently on offers under the VDO that will either be placed onto the higher VDO price with any attached benefits lost, or be retained on their current offer (under the VDO) but also losing benefits, because their retailer has had to adjust their prices to cover actual costs. The consequence is the VDO will force a reduction of attractive market offers available to customers under the VDO price. Eventually those retailers may also leave the market, leading to Morgan Stanley’s conclusion that other retailers with generation support will acquire these customers with little competitive pressure.

Based on available evidence and feedback from the energy industry and external resources referenced in this submission, the MEA Group believes the best approach is that Victoria transitions to the DMO, limiting the risks associated with the VDO impacting vulnerable, price sensitive engaged customers and any future customers in Victoria.

Notwithstanding this, at a minimum the MEA Group asks for the adoption of a more cautious, considered and measured approach in order to mitigate and reduce the impacts on prices, competition, innovation and investment for the next six months and avoid an increased revision of the VDO price for 1 January 2020.

The Minister and the DELWP should consider these materially adverse effects on Victorian customers, the energy market and ultimately the Victorian economy by deferring the OIC until 1 January 2020 at a minimum, and undertaking an appropriate, stepped process of implementation of the OIC.

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

Yours sincerely,



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¹² Herald Sun, Power to the big retailers, John Dagge, Melbourne, 23 April 2019, page 44