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18 October 2019

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Default Market Offer Price 2020-21 Position Paper

Meridian Energy Australia Pty Ltd and Powershop Australia Pty Ltd (MEA Group or Powershop) thanks the Australian Energy Regulator (AER) for the opportunity to provide comments on the AER's Default Market Offer Price 2020-21 Position Paper (the Paper).

Background on the MEA Group

MEA Group is a vertically integrated generator and retailer focused entirely on renewable generation. We opened our portfolio of generation assets with the Mt Millar Wind Farm in South Australia, followed by the Mt Mercer Wind Farm in Victoria. In early 2018 we acquired the Hume, Burrinjuck and Keepit hydroelectric power stations, further expanding our modes of generation. We have 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 is an innovative retailer committed to providing low 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 several 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. 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 working alongside our customers to fund a large range of community and social enterprise energy projects through our Your Community Energy program.

General comments

Powershop believes the Default Market Offer (DMO) price methodology which used the mid-way point between the median standing and market offers for the Default Market Offer Price 2019-20 (DMO 1) was too severe. Since 1 July this has resulted in a reduction in offers, products, discounts and various benefits across the NEM (excluding Victoria), with a convergence towards to the DMO, indicating a reduction in competition. On this basis, Powershop does not agree that the objective of not reducing incentives for competition has been achieved.

This view is now more critical as the AER is seeking to apply a reference price to non-flat tariffs (e.g. solar, Time of Use and demand customers). Powershop supports the AER providing industry with a reasonable timeframe to consult and determine non-flat tariff prices however, Powershop believes that the AER should not implement a DMO and reference price for non-flat tariffs until 1 January 2021. Customers and the industry should be provided with at least 12 months of DMO1 data and research before any further implementation.

If the AER applies a DMO and reference price to non-flat tariffs, setting it at the 80th percentile between the range of median market and standing offers is an appropriate introductory approach, in order to appropriately reset prices and ensure customers already engaged in the market are not impacted as they were under DMO 1.

Set out below are responses to the questions raised in the Paper.

Section 3 - Approaches to setting the DMO annual price

1. For our DMO 2 price determination, do you agree with our proposed approach of carrying forward the DMO 1 price whilst taking into account the changes in forecast changes in input costs?

   Powershop agrees with the AER's proposed approach to carry forward DMO 1 if the most recent data is appropriately applied. Carrying over DMO 1 will assist customers and industry to improve their understanding as to how the new, complex DMO framework impacts the market and customers. This decision also creates less disruption when complex non-flat tariffs will need to be implemented against a reference price.

Section 4 - Forecasting changes in the retailer's cost of supply

3. Does our representative retailer broadly reflect retailers in each of the markets the DMO will apply?

   Powershop is generally supportive of the AER's approach in assessing the forecast changes in input costs up to 2020-21. However, in order to appropriately consider these changes the AER should consider at a minimum the following items:

   - the time period to assess changes in forecast costs should be as close to the DMO period as possible to enable the change in wholesale cost and hedging assumptions to appropriately align with the wholesale estimate based on upcoming ACIL Allen modelling;
   - when ACIL Allen applies its environmental cost estimates, their assumptions should be applied to reflect the published renewable power percentage and the small-scale technology percentage. This was not reflected in DMO 1;
   - Powershop believes the AER needs to consider forecasting metering costs given the higher costs associated with third-party (non-distributor) contestable smart meters, noting additional meter recovery and other costs. Retailers were obliged to implement smart meters as a response to the Power of Choice rule change. As we stated in our March 2019 submission, these costs will continue to increase so we believe it is appropriate to include these costs; and
   - the AER should allow for the significant forecast risk in relation to the changing customer load of all retailers. All retailers must forecast changes in customer load, making assumptions in sales, churn and customer load across a changing customer mix. This risk premium is built into a prudent and risk adverse retailer's hedging strategy.

Section 4.1 - Wholesale electricity costs

5. Do you consider the use of the NSLP and CLP is an appropriate proxy to model a representative retailer's load profile?

   Powershop does not agree that there is limited value in separating the Network System Load Profile (NSLP) into residential and small business customer profiles. As seen during the Essential Service Commission of Victoria's (ESC) calculation of the Victorian Default Price (VDO), separating the load profiles had a significant impact on both the residential and business VDO prices.

   Any profile used to estimate a particular retailer's cost base should be fully representative of their customer base. Utilising data which is inclusive of larger and less variable customers results in an underestimate of wholesale electricity costs for smaller, more volatile, and ultimately more expensive customers.

   Powershop believes that customers with cheaper loads to hedge should experience the benefit of their consumption patterns. This is particularly important in a system where matching supply and demand becomes increasingly difficult to achieve and measures to incentivise efficient consumption are being implemented.

Powershop and ACIL Allen are aligned in their view that load profiles become peakier over time. Powershop believes this has wide-reaching consequences for the wholesale cost base associated with residential customers. Powershop supports ACIL Allen's view that it is unlikely that demand from historical years will be perfectly repeated in subsequent years.

ACIL Allen's methodology utilises 4 years of half-hourly demand profiles however, it is not clear whether these are weighted evenly or if more weighting is given to more recent years. Applying such a long time frame for the historical data can reduce the impact of recent trends and does not account for the rapid changes taking place in the market. Powershop suggests a smaller time frame should be applied.

6. Do you consider the proposed hedging strategy is appropriate?

   Powershop believes the hedging strategy is unsuitable for minimising the range of outcomes in wholesale energy costs faced by a retailer.

   Retailers face uncertainty over customer numbers and load in any particular time period. With increasing time there is an increased amount of uncertainty. Customer loads can change due to any number of reasons, including but not limited to the competitive landscape, regulatory interventions and seasonal behaviours. Hedging with perfect foresight obviously reduces the possible range of cost outcomes but adapting portfolios and delta-hedging as required can drastically change cost, and therefore, margin outcomes.

   Powershop questions the basis for the 10 and 5 percentile increments for base/peak and cap products respectively. It appears there is no data supporting these percentiles.

7. Do you consider there are improvements to the ACIL Allen Consulting's proposed wholesale cost forecast methodology?

   A greater number of simulations should be conducted to better establish a larger range of outcomes and to better capture tail risks that prudent retailers maintain capital reserves, at a cost, to mitigate. Simulations should also be conducted for various magnitudes of customers to gain a more comprehensive understanding of varying costs across different customer segments.

Section 4.2 - Environmental costs

8. Do you consider there are improvements to the ACIL Allen Consulting's proposed environmental cost forecast methodology?

   Limiting the use of simple averages and more consideration of environmental hedging time frames may help to provide a better estimate of costs likely to be incurred by retailers in the procurement of environmental products.

Section 4.3 - Network Costs

9. Are the proposed tariffs appropriate for assessing network cost changes?

   The AER states 'whilst the New South Wales distribution network tariffs may be approved by 31 April 2020, SAPN and Energex tariffs will not be available as the regulatory determination process for these distribution zones will only be completed by the end of April 2020".[1] Although Powershop acknowledges that the AER is bound to make a DMO determination by 1 May, without the required network tariff approvals Powershop does not believe the forecast to be applied for DMO 2 is valid and suggest deferring the forecast if possible.

Section 4.4 - Residual costs

10. Do stakeholders have additional information we should consider in relation to the proposed adjustments to the residual costs?

    Powershop agrees with the calculation of the costs from DMO 1 but does not believe CPI appropriately reflects the true, higher cost increases, due to regulatory and other changes, in the market that a retailer incurs. Powershop will continue to incur costs for innovation and development to provide a greater customer experience, service standards and product options. The innovation that Powershop delivers into the market, providing long term market-wide customer benefits, lower costs and reduced consumption is at risk.

[1] Australian Energy Regulator Position paper – Default Market Offer 2020-21, Page 36

The current energy transformation to an increased reliance on renewable energy and decentralised participation cannot occur without costs being incurred, they should be allowed for in setting the DMO 2. The market is becoming increasingly reliant on retailers leading the innovation on industry projects including demand response, virtual power plants and peer to peer trading.

Section 4.5 - Step Change Framework for material changes in retailer costs

11. Do you consider our step change framework is appropriate?

Powershop broadly agrees with the AER's step change framework, however we note that potential step changes to retailer's costs are caused by a broad range of initiatives, not just regulatory and market interventions.

13. Do you agree with our initial assessment of potential step changes?

Powershop notes that the AER aligns its position to that of the ESC regarding the Retailer Reliability Obligation (RRO). As we advised in our recent submission to the ESC's upcoming final decision on their 1 January 2020 VDO, the "position ignores the requirement for retailers to be hedged to their one-in-two forecast peak demand one year in advance of a reliability gap period. We also previously advised that Frontier Economics has ignored current industry practice adopted by prudent, efficient retailers whereby they enter into hedges to meet the RRO obligations in the 6-12 month period prior to it taking effect, in total and on average 18 months prior".[2]

Section 5 - Model annual usage

14. What additional information should we consider in relation to the proposed usage assumptions?

Powershop has numerous concerns in relation to the proposed usage assumptions. Whereas the data from each distribution business data is 'recent', it relies on subsequent periods to be identical to previous periods. This contrasts with the market where there are observable trends in both volume and shape of loads, and subsequently spot exposure, faced by retailers.

Additionally, it is not known if the data used to derive the annual volumes has been adjusted to remove weather effects. A full regression analysis should be carried out to allow for more accurate estimation of loads in an average year.

Powershop believes load magnitudes and shape should be reviewed for solar customers in isolation to determine the scale of difference between solar and non-solar customers. Additionally, business and non-business days should be considered separately due to the array of hedging products which might be utilised to adjust exposures to these particular day types. The extent to which solar customer consumption volumes are 'broadly similar' to non-solar customers should be provided on a quantitative basis.

Whilst Powershop agrees that the extent of differences in household consumption for solar and non-solar customers might be marginal, the observable change in load shape needs to be considered in greater detail. Higher relative morning and evening peaks of solar customers contribute greatly to wholesale costs experienced by retailers.

Section 6.1 – Time of Use

16. Have we appropriately balanced the policy objectives in our proposed approach to assessing a DMO price for time-of-use tariffs?

Powershop agrees that retailer's annual Time of Use (TOU) prices should be compared to the flat DMO price regardless of whether a controlled load applies. However, Powershop suggests as noted above that any DMO price applied to TOU tariffs should be applied in the same conservative method we have prescribed for the existing flat rate DMO, to ensure that the objective to "not reduce incentives for competition, innovation and market participation by customers and retailers"[3] is achieved.

In addition, more analysis should be undertaken regarding the difference in the timing of consumption of solar and non-solar households on TOU tariffs. This has the potential to create inefficient cross-subsidises.

[2] Meridian Energy Powershop, submission to the Victorian Default Offer to apply from 1 January 2020 Draft Decision, Page 3

[3] Australian Energy Regulator, Position Paper Default Market Offer Price 2020-21, Page 10

17. Are there other data sources or factors we should take into consideration if we are required to determine a DMO price for time-of-use tariffs?

    Powershop does not agree with the assumption "that, due to the comparatively small number of customers on TOU standing offers, the revenue impacts on retailers are unlikely to be significant"[4] in relation to retailer costs and the gap in network costs for a flat and non-flat tariff customer.

    Powershop recommends changes that would obligate a network distributor to, at a minimum, ensure that they reassign the relevant tariff based upon a customer's choice.

Section 6.2- Solar

18. Do stakeholders consider the proposed approach would appropriately balance the policy objectives if we are required to determine a DMO price for solar tariffs?

    Powershop believes the AER should apply a similar, conservative approach, as referred to in our response to Question 16, to ensure that solar customers do not lose any of their benefits as a result of the implementation of a DMO price. A DMO price for solar tariffs does not reflect the intention of the DMO to remove exorbitant standing offers. It would be helpful if the AER could provide evidence to demonstrate that solar customers are exposed to prices at a level that would require a DMO price to be applied.

    Retailers are incentivised to provide solar customers with benefits and discounts to encourage customers to sign up to a solar offer. Powershop also offers its solar customers a Feed-in-Tariff rate that is above the relevant, minimum government benchmarks. Expanding DMO prices to TOU will impact more solar customers and limit the number of innovative offers made available.

Powershop agreed with the AEMC advice prior to DMO 1 there was a major risk in setting default prices at levels that would diminish participation and competition by retailers and substantially reduce the benefits customers will achieve from the market. Powershop notes those risks remain with DMO 2, especially with the introduction of non-flat tariffs. We are encouraged that the AER continues to consult with industry and continues to engage with ACIL Allen as to how wholesale and environmental costs will be estimated.

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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[4] Australian Energy Regulator, Position Paper Default Market Offer Price 2020-21, Page 49