17 October 2019

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

Submitted via https://engage.vic.gov.au

Re: Victorian Default Offer to apply from 01 January 2020

I refer to your Victorian Default Offer draft advice (VDO) setting out a methodology and approach for determining a fair and efficient price for electricity for Victorian residential and small business customers and provide thanks to the Essential Services Commission Victoria (Commission) for the opportunity to provide a submission.

1st Energy is a non-integrated, second-tier electricity and gas retailer for residential and SME customers. Founded in April 2015, 1st Energy operates throughout the eastern states of Australia including New South Wales, Queensland, Tasmania and Victoria.

Collectively, industry continues working to facilitate a competitive, dynamic energy market, with more engaged consumers; affordability remaining at the forefront of public debate. The Victorian market is now underpinned by the Victorian Default Offer (VDO) and there is an economic imperative to deliver a fair price for customers balanced against retaining a sustainable market that retailers can continue to participate in.

1st Energy provides the following commentary on the proposed pricing methodology and inputs for determining VDO prices.

Wholesale Electricity Costs

The Commission proposes a 'futures market' method to estimating the wholesale electricity costs included in setting the VDO prices and have engaged the services of Frontier Economics to perform the modelling.

The futures market method requires inputs for:

- The likely half-hourly load of the retailer's customers;
- The corresponding likely half-hourly spot prices the retailer will face;
- The cost of financial hedging contracts that retailers will face; and
- The hedging position a retailer is likely to adopt.

Our key concerns with the modelling/formulas used by Frontier Economics in determining the wholesale electricity cost input are:

- The inclusion of National Electricity Market (NEM) spot price data for Victoria for FY17 should be excluded, as the closure of Hazelwood fundamentally changed the dynamics of the wholesale market and its relationship to demand in FY17 is no longer representative of today's market; we propose that only FY18 and FY19 should be used.

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- There appears to be an error with the spot price $/MWh in the spreadsheets published by Frontier Economics. The maximum spot price (VoLL) for 2020 will be $14,700.00, but the spreadsheet contains a figure of $16,912.27 on 26/03/2017. This results in an overstatement of the payout from the assumed hedge contract, thus resulting in a lower overall wholesale energy cost.
- We encourage the use of ASX Energy data as close as possible to the period prices are being set and at a minimum consider utilising data up to 31 October 2019 to be a fairer representation.
- The allowance for forecasting deviation appears too low. The overall risk adjusted premium of approximately 20% above the base swap price for wholesale energy costs is out of step with load following contracts, which best reflect the hedging strategy of the frontier approach. In our experience load following contracts have a shape premium cost well in excess of 20%.

Network losses

1st Energy agrees with the Commission's approach to utilising to use data available from the Australian Energy Market Operator for distribution loss factors and marginal loss factors.

Network costs

1st Energy agrees that in setting the VDO the Australian Energy Regulator approved network costs must be included to ensure a true and accurate representation of the costs in providing retail electricity services.

Environmental scheme and other regulatory costs

In setting the environmental costs 1st Energy asks the Commission to consider the following:

- Large-scale Renewable Energy Target (LRET) – as an alternative to using the default Renewable Power Percentage (RPP) price to set the LRET we propose the Commission engage with the Clean Energy Regulator (CER) for the most accurate and up to date price. This will assist with the avoidance of significant over or under-recovery associated with changes to renewable obligations in the 2020 VDO price determination.
- Small-scale Renewable Energy Scheme (SRES) – again we encourage the Commission to liaise with the CER to seek advice on the likely binding small-scale technology percentage (STP) given previous periods have had significant variances[1]. The non-binding STP is set at 14.56% for the 2020 year whilst this period's actual STP is 21.73%. The variance year on year between the non-binding STP and the actual STP was evidenced in calendar year 2018 when the non-binding STP was 8.06% and the actual was 17.08% and again in calendar year 2019 when the non-binding STP was 12.13% and the actual was 21.73%. Setting the STP too low creates a false price expectation for consumers, creates price risk and is likely to result in an under-recovery (price increase) in the second regulatory period.

Retailer Operating Costs

We understand in setting the VDO the Commission's approach is to have regard to the efficient costs of providing retail electricity services, utilising market-based data. Given the Commission has now received information from all retailers, we are supportive of the Commission setting the allowance for retailer operating costs (ROC) based on the actual ROC of existing retailers. In our view, utilisation of the Independent Competition and Regulatory Commission (ICRC) ROC is not an accurate reflection of the costs borne in the Victorian market and the ACT cannot be considered a comparative market. Following on from the Commission's review of the retailer information we look forward to increased transparency on the setting of the ROC and the associated cost stack.
Specifically, we ask that the Commission consider:

[1] http://www.cleanenergyregulator.gov.au/RET/Scheme-participants-and-industry/the-small-scale-technology-percentage

- Defining an efficient retailer - as per our previous submission our concerns remain with the use of ROC figures produced by publicly listed retailers which include significant offshoring of back office functions. Outsourced providers offer a lower cost to serve and this utilisation assumption will lead to offshore outsourcing and ultimately Victorian job losses. The efficient retailer model adopted by the Commission is skewed towards the larger, vertically integrated retailers and diametrically opposed to the promotion of competition. In determining an efficient retailer, we ask that the Commission have regard to the domestically harmful repercussions of outsourcing labour which is a prerequisite to reflect these efficient costs.
- The information provided to the Commission is based on an individual electricity customer and not spread across other functions of a multi-utility organisation.
- Following on from implementation of the payment difficulty framework (PDF) our initial assessment is that bad debt is likely to increase. As a result of PDF, debt is now accumulating over an extended period with recovery uncertain, exacerbated by increasing energy costs and the impacts to cost to serve are not considered in the pricing of the VDO. The impact of PDF is placing upward pressure on working capital and increasing bad debt, so the long-term position for FY20 and beyond is that we are forecasting adverse financial impacts relating to PDF.

Customer acquisition and retention costs

In the draft decision the customer acquisition and retention costs (CARC) have been set at $38.00, the NEM-wide average for 2013-14 (adjusted for inflation) from the ACCC inquiry final report[2]. Whilst we understand the order only permits a modest allowance basing the CARC on a 2013-2014 benchmark is counterintuitive to the current market environment and in our view at a level that incentivises consumer disengagement.

The Commission now has available retailer information which includes a section on cost categories, and we urge the Commission to use this data as a cross check against the allowance calculated in the draft decision in preparation of the final decision.

1st Energy thanks the Commission for the opportunity to provide a submission. For any queries regarding this response, please contact Aneta Graham, Head of Regulatory and Compliance, aneta.graham@1stenergy.com.au, 03 7001 3724.

Yours sincerely

Liam Foden
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[2] https://www.accc.gov.au/system/files/Retail%20Electricity%20Pricing%20Inquiry%E2%80%94Final%20Report%20June%202018_0.pdf